91-1902

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Supreme Court, U.S.
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MAY 27 1992
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NO._____

IN THE

**SUPREME COURT OF THE UNITED STATES**

October Term, 1991

**GREYSTONE III JOINT VENTURE,**

Petitioner

v.

**PHOENIX MUTUAL LIFE INSURANCE COMPANY,**

Respondent

**ON WRIT OF CERTIORARI TO THE FIFTH CIRCUIT COURT OF APPEALS**

# APPENDIX TO PETITION FOR WRIT OF CERTIORARI

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UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

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NO. 90-8529

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D.C. DOCKET NO. A-89-CA 667

In the Matter of

GREYSTONE III JOINT VENTURE, Debtor

PHOENIX MUTUAL LIFE INSURANCE COMPANY,
Appellant,

v.

GREYSTONE III JOINT VENTURE,
Appellee.

Appeal from the United States District
Court for the Western District

Before REYNALDO G. GARZA, POLITZ and JONES,
Circuit Judges.

JUDGMENT

This cause came on to be heard on the record on appeal and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the District Court affirming the bankruptcy court's confirmation of Greystone's

plan of reorganization is reversed, and the cause is remanded to the District Court for further proceedings in accordance with the opinion of this Court.

IT IS FURTHER ORDERED that appellee pay to appellants the costs on appeal to be taxed by the Clerk of this Court.

November 19,1991

ISSUED AS MANDATE: May 4, 1992

In the Matter of
GREYSTONE, III JOINT VENTURE, Debtor.

PHOENIX MUTUAL LIFE
INSURANCE COMPANY,
Appellant,
v.
GREYSTONE III JOINT VENTURE,
Appellee.

No. 90-8529.
United States Court of Appeals,
Fifth Circuit.

Feb. 27, 1992.

Appeal from the United States District Court For the Western District of Texas; Walter S. Smith, Jr., Judge.

ON PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

(Opinion November 19, 1991, 5th Cir., 1991, 948 F.2d 134)

Before POLITZ, Chief Judge, REYNALDO G. GARZA and JONES, Circuit Judges.

PER CURIAM:

A majority of the panel having voted to grant rehearing in part, the opinion of the court in disposing of this appeal is as follows:

Part IV of the panel opinion, found at 948 F.2d

134, 142-44 (5th Cir.1991), is hereby withdrawn and deleted from the opinion. In connection with that determination, the last paragraph of Part III also is deleted. Further, in the first sentence of the second paragraph of the opinion, the word "three" is changed to "two," and the last sentence of that paragraph is deleted. Part V of the opinion is renumbered to IV. In withdrawing this portion of the panel opinion we emphasize that the bankruptcy court's opinion on the "new value exception" to the absolute priority rule has been vacated and we express no view whatever on that part of the bankruptcy court's decision.

Other than these revisions, the original opinion is reinstated and the petition for panel rehearing is DENIED. Further, no member of the panel or judge in active service having requested that the court be polled on rehearing en banc, see Fed.R.App.P. and Local Rule 35, the suggestion for rehearing en banc is DENIED.

EDITH H. JONES, Circuit Judge, dissenting:

How one should approach issues of a statutory

construction arising from the Bankruptcy Code has been clouded, in my view, by *Dewsnup v. Timm*, --- U.S. ----, 4112 S.Ct. 773, --- L.Ed.2d ---- (1991). Nevertheless, in reaffirming what I wrote about the "new value exception" in Part IV of the original opinion, and therefore in voting against a rehearing, I would hope to stand with Galileo, who, rebuffed by a higher temporal authority, muttered under his breath, "Eppur si muove." ("And yet it moves.")

In the Matter of

GREYSTONE III JOINT VENTURE, Debtor

PHOENIX MUTUAL LIFE INSURANCE COMPANY,
Appellant

v.

GREYSTONE III JOINT VENTURE,
Appellee

No. 90-8529

United States Court of Appeals
Fifth Circuit

November 19, 1991

EDITH H. JONES, Circuit Judge:

This appeal pits a debtor whose only significant asset is an office building in the troubled Austin, Texas real estate market against a lender who possesses a multi-million dollar lien on the property. After obtaining bankruptcy relief under Chapter 11, Greystone III proposed a "cramdown" plan of reorganization, hoping to force a write-down of over $3,000,000 on the secured lender's note and to retain possession and full ownership of the property. Over the secured lender's strenuous

objections, the bankruptcy court confirmed the debtor's plan. *In re Greystone III Joint Venture*, 102 B.R. 560 (W.D.Tex.1989). On appeal, the district court upheld the bankruptcy court's judgment. 127 B.R. 138.

For three reasons, we must reverse. First, the Greystone plan impermissibly classified like creditors in different ways and manipulated classifications to obtain a favorable vote. Second, tenant security deposit holders were not properly deemed an "impaired" class under the circumstances of this plan. Third, because we find no "new value exception" to the absolute priority rule codified in 11 U.S.C. § 1129(b)(2)(B), that rule was violated by Greystone's plan.

I.

Appellant Phoenix Mutual Life Insurance Corporation ("Phoenix") lent $8,800,000, evidenced by a non-recourse promissory note secured by a first lien, to Greystone to purchase the venture's office building. When Greystone defaulted on the loan, missing four payments, Phoenix posted the proper-

ty for foreclosure. Greystone retaliated by filing a Chapter 11 bankruptcy reorganization petition.[1]

At the date of bankruptcy Greystone owed Phoenix approximately $9,325,000, trade creditors approximately $10,000, and taxing authorities approximately $145,000. The bankruptcy court valued Phoenix's secured claim at $5,825,000, the appraised value of the office building, leaving Phoenix an unsecured deficiency of approximately $3,500,000--the difference between the aggregate owed Phoenix and its secured claim.

As filed, Greystone's Second Amended Plan of Reorganization (the "Plan"), the confirmation of which is challenged in this appeal, separately classified the Code-created unsecured deficiency claim of Phoenix-Mutual, *See* 11 U.S.C. § 1111(b),

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[1] No issue concerning the "good faith" of Greystone's Chapter 11 filing has been raised in the papers pertinent to this appeal. *Compare In re Humble Place Joint Venture*, 936 F.2d 814 (5th Cir.1991); *In re Little Creek Dev. Co.*, 779 F.2d 1068 (5th Cir.1986).

and the unsecured claims of the trade creditors. The Plan proposed to pay Phoenix and the trade creditors slightly less than four cents on the dollar for their unsecured claims, but it also provided that Greystone's general partner would satisfy the balance of the trade creditors' claims after confirmation of the Plan.

In a separate class, the Plan further provided for security deposit "claims" held by existing tenants of the office building. These claimants were promised, notwithstanding the debtor's eventual assumption of their leases, 11 U.S.C. § 365, 25% of the their deposits upon approval of the Plan and 50% of their deposits at the expiration of their respective leases. The Plan stipulated that the general partner would "retain its legal obligations and . . . pay the [tenant] . . . creditors the balance of their claims upon confirmation."

Finally, Greystone's Plan contemplated a $500,000 capital infusion by the debtor's partners, for which they would reacquire 100% of the equity interest in the reorganized Greystone Unsurprising-

ly, Phoenix rejected this Plan, while the trade creditors and the class of holders of tenant security deposits voted to accept it. On January 27, 1989, the bankruptcy court held a confirmation hearing at which the Debtor orally modified its Plan to delete the statements that the general partner would pay the balance of trade debt and tenant security deposit claims after confirmation. A Phoenix representative testified that the insurance company was willing to fund its own plan of reorganization by paying off all unsecured creditors in cash in full after confirmation. The bankruptcy court refused to consider this proposal and then confirmed Greystone's modified Plan. The district court upheld the confirmation.

Phoenix Mutual now appeals on several grounds: (a) the plan classified Phoenix's unsecured deficiency claim separately from that of other unsecured creditors for no valid reason; (b) the "new value exception" to the absolute priority rule did not survive passage of the Bankruptcy Code; and (c) unpaid tenant security deposits were not im-

paired claims that could vote on the plan.[2]

II.

Phoenix first attacks Greystone's classification of its unsecured deficiency claim in a separate class from that of the other unsecured claims against the debtor. This issue benefits from some background explanation.

Chapter 11 requires classification of claims against a debtor for two reasons. Each class of creditors will be treated in the debtor's plan of reorganization based upon the similarity of its members' priority status and other legal rights against the debtor's assets. 11 U.S.C. § 1122. Proper classification is essential to ensure that

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[2] Because the case is resolved on these issues, we need not discuss appellant's further contention that additional disclosure was required after the debtor orally modified its plan at the confirmation hearing.

creditors with claims of similar priority against the debtor's assets are treated similarly. Second, the classes must separately vote whether to approve a debtor's plan of reorganization. 11 U.S.C. § 1129(a)(8),(10). A plan may not be confirmed unless either (1) it is approved by two-thirds in amount and more than one-half in number of each "impaired" class, 11 U.S.C. §§ 1126(c), 11129(a)(8); or (2) at least one impaired class approves the plan, § 1129(a)(10), and the debtor fulfills the cramdown requirements of § 1129(b) to enable confirmation notwithstanding the plan's rejection by one or more impaired classes. Classification of claims thus affects the integrity of the voting process, for, if claims could be arbitrarily placed in separate classes, it would almost always be possible for the debtor to manipulate "acceptance" by artful classification.

In this case, Greystone's plan classified the Phoenix claim in separate secured and unsecured classes, a dual status afforded by 11 U.S.C. § 1111(b) despite the non-recourse nature of Phoe-

nix's debt. Because of Phoenix's opposition to a reorganization, Greystone knew that its only hope for confirmation lay in the Bankruptcy Code's cramdown provision. 11 U.S.C. § 1129(b). The substantive impact of cramdown will be discussed later. Procedurally, Greystone faced a dilemma in deciding how to obtain the approval of its cramdown plan by *at least one* class of "impaired" claims, as the Code requires.[3] 11 U.S.C. § 1129(a)(10). Greystone anticipated an adverse vote of Phoenix's secured claim. If the Phoenix $3.5 million unsecured deficiency claim shared the same class as Greystone's other unsecured trade claims, it would swamp their $10,000 value in voting against confirmation. The only other arguably impaired class consisted of tenant security

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[3] An impaired claim is defined at 11 U.S.C. § 1124. For present purposes, it suffices to say that Phoenix was impaired both as a secured and unsecured creditor.

deposit claims, which, the bankruptcy court found, were not impaired at all.

Greystone surmounted the hurdle by classifying Phoenix's unsecured deficiency claims separately for the trade claims, although both classes were to be treated alike under the plan and would receive a cash payment equal to 3.42% of each creditor's claim. Greystone then achieved the required favorable vote of the trade claims class.

Phoenix contends that Greystone misapplied § 1122 by classifying its unsecured claim separately from those of trade creditors. The lower courts rejected Phoenix's argument in three steps. First, they held that § 1122 of the Code does not unambiguously prevent classification of like claims in separate classes. The only question is what types of class differentiations among like claims are acceptable. Second, Greystone's unsecured deficiency claim is "legally different" from that of the trade claims because it arises statutorily, pursuant to § 1111(b). Third, "good business reasons" justify the separate classification of these unsecured

claims. We must address each of these arguments.

Section 1122 prescribes classification of claims for a reorganization as follows:

> (a) Except as provided in subsection (b) or this section, a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such claims.
>
> (b) A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.

We observe from this language that the lower courts' suggestion that § 1122 does not prevent classification of like claims in separate classes is oversimplified. It is true that § 1122(a) in terms only governs permissible *inclusions* of claims in a class rather requiring that all similar claims be grouped together. One cannot conclude categori-

cally that § 1122(a) prohibits the formation of different classes from similar types of claims. But if § 1122(a) is wholly permissive regarding the creation of such classes, there would be no need for § 1122(b) specifically to authorize a class of smaller unsecured claims, a common feature of plans in reorganization cases past and present.[4] The broad interpretation of § 1122(a) adopted by the lower courts would render § 1122(b) superfluous, a result that is anathema to elementary principles of statutory construction.

Section 1122 consequently must contemplate some limits on classification of claims of similar

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[4] Greystone has never sought to justify its separate class of trade creditors under § 1122(b), nor did the lower courts employ that provision in their analysis. There is no suggestion in the Code, however, that a class may be created under § 1122(b) in order to manipulate the outcome of the vote on a plan, rather than simply to enhance administration of the plan.

priority. A fair reading of both subsections suggests that ordinarily "substantially similar claims," those which share common priority and rights against the debtor's estate, should be placed in the same class. Section 1122(b) expressly creates one exception to this rule by permitting small unsecured claims to be classified separately from their larger counterparts if the court so approves for administrative convenience. The lower courts acknowledged the force of this narrow rather than totally permissive construction of § 1122 by going on to justify Greystone's segregation of the Phoenix claim. Put otherwise, the lower courts essentially found that Phoenix's unsecured deficiency claim is not "substantially similar" to those of the trade creditors.

Those courts did not, however, adhere to the one clear rule that emerges from otherwise muddled case law on § 1122 claims classification: thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan.

As the Sixth Circuit observed:

> [T]here must be some limit on a debtor's power to classify creditors in such a manner. . . . Unless there is some requirement of keeping similar claims together, nothing would stand in the way of a debtor seeking out a few impaired creditors (or even one such creditor) who will vote for the plan and placing them in their own class.

*In re U.S. Truck Co.*, 800 F.2d 581, 586 (6th Cir.1986). *See also In re: Holywell Corp.*, 913 F.2d 873 (11th Cir.1990); *Hanson v. First Bank of South Dakota*, 828 F.2d 1310, 1313 (8th Cir.1987); *In re Lumber Exch. Ltd. Partnership*, 125 B.R. 1000, 1005-1006 (Bankr.Minn.1991); *In re Waterways Barge Partnership*, 104 B.R. 776, 783-86 (N.D.Miss.1989) (good discussion); *In re Mastercraft Record Plating, Inc.*, 32 B.R. 106, 108 (Bankr.S.D.N.Y.1983), *rev'd on other grounds*, 39 B.R. 654 (S.D.N.Y.1984). We agree with this rule, and if Greystone's proffered "reasons" for separate-

ly classifying the Phoenix deficiency claim simply mask the intent to gerrymander the voting process, that classification scheme should not have been approved.

Greystone's reliance on *Brite v. Sun Country Development, Inc.*, 764 F.2d 406 (5th Cir.1985), as an allegedly contrary rule is misplaced. That case allowed the debtor to impair a previously unimpaired class of creditors not for purposes of vote-getting but because the debtor belatedly discovered that it did not have sufficient funds to pay the creditors' claims in full. The court found that the debtor's decision to reclassify previously unimpaired creditors as impaired was necessary. *Id.* at. 408. *Sun Country* does not support Greystone's argument that plan proponents possess unlimited discretion to classify unsecured claims separately. We conclude that if § 1122(a) permits classification of "substantially similar" claims in different classes, such classification may only be undertaken for reasons independent of the debtor's motivation to secure the vote of an impaired, assenting class of

claims. To those proffered reasons we now turn. Greystone contends that the "legal difference" between Phoenix's deficiency claim and the trade creditors' claims is sufficient to sustain its classification scheme. The alleged distinction between the legal attributes of the unsecured claims is that under state law Phoenix has no recourse against the debtor personally. However, state law is irrelevant where, as here, the Code has eliminated the legal distinction between non-recourse deficiency claims and other unsecured claims. *See* 11 U.S.C. § 1111(b)(1)(A); *In re Tampa Bay Associates, Ltd.*, 864 F.2d 47 (5th Cir.1989) *Hanson*, 828 F.2d at 1313.[5]

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[5] Greystone argues that *Hanson* is not controlling because the issue there was whether it was clearly erroneous for the bankruptcy court to *deny* separate classification whereas the issue here is whether it was clearly erroneous for the court to *approve* the classification. The clearly erroneous rule has no application in this context. Whether a deficien-

The purpose of § 1111(b) is to provide an under-secured creditor an election with respect to the treatment of its deficiency claim. Generally, the creditor may elect recourse status and obtain the right to vote in the unsecured class, or it may elect to forego recourse to gain an allowed secured claim for the entire amount of the debt. If separate classification of unsecured deficiency claims arising from non-recourse debt were permitted solely on the ground that the claim is non-recourse under state law, the right to vote in the unsecured class would be meaningless. Plan proponents could effectively disenfranchise the holders of such

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cy claim is legally similar to an unsecured trade claims turns not on fact findings but on their legal characteristics. This is an issue of law, freely reviewable on appeal. *See Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1307 (5th Cir.1985). Subsidiary fact findings however, may be entitled to the deference of the clearly erroneous test. *Id.*

claims by placing them in a separate class and confirming the plan over their objection by cram-down. With its unsecured voting rights effectively eliminated, the electing creditor's ability to negotiate a satisfactory settlement of either its secured or unsecured claims would be seriously undercut. It seems likely that the creditor would often have to "elect" to take an allowed secured claim under § 1111(b)(2) in the hope that the value of the collateral would increase after the case is closed.[6]

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[6] In this case, for example, Greystone proposed to extinguish Phoenix's $3,500,000 deficiency claim by the promised payment of $140,000. Under the valuation process, it confined Phoenix's secured claim to $5.8 million. 11 U.S.C. § 506(a). Phoenix obviously objects to this arrangement because, in the future, it might ultimately receive more than the written-down value of the office building in a liquidation following foreclosure. Yet, with its voting rights effectively eliminated by separate classification. Phoenix has no lever-

Thus, the election under § 1111(b) would be essentially meaningless. We believe Congress did not intend this result.

As the bankruptcy court viewed this issue, the debtor's ability to achieve a cramdown plan should be preferred over the creditor's § 1111(b) election rights because of the Code's policy of facilitating reorganization. The bankruptcy court resorted to policy considerations because it believed Congress did not foresee the potential impact of an electing creditor's deficiency claim on the debtor's aspiration to cramdown a plan. We disagree with this approach for three reasons. First, it results here in

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age to persuade the Debtor to consider a more reasonable settlement. Had this scenario triumphed, Phoenix's most realistic option might have been to take an allowed secured claim in the hope that eventually the market value of the office building will increase by more than $140,000 over the presently estimated value of the collateral.

violating § 1122, by gerrymandering the plan vote, for the sake of allegedly effectuating a § 1129(b) cram-down. "Policy" considerations do not justify preferring one section of the Code, much less elevating its implicit "policies" over other sections, where the statutory language draws no such distinctions. Second, as shown, it virtually eliminates the § 1111(b) election for secured creditors in this type of case. Third, the bankruptcy court's concern for the viability of cramdown plans is overstated. If Phoenix's unsecured claim were lower and the trade debt were higher, or if there were other impaired classes that favored the plan, a cramdown plan would be more realistic. That Greystone's cramdown plan may not succeed on the facts before us does not disprove the utility of the cramdown provision. The state law distinction between Code-created unsecured deficiency claims and other unsecured claims does not alone warrant separate classification.

Greystone next argues that separate classification was justified for "good business reasons." The

bankruptcy court found that the debtor "need[s] trade to maintain good will for future operations." *In re Greystone III Joint Venture, supra* at 570. The court further reasoned:

> [I]f the expectation of trade creditors is frustrated . . . [they] have little recourse but to refrain from doing business with the enterprise. The resulting negative reputation quickly spreads in the trade community, making it difficult to obtain services in the future on any but the most onerous terms.

*Id.* Greystone argues that the "realities of business" more than justify separate classification of the trade debt from Phoenix's deficiency claim. This argument is specious, for it fails to distinguish between the *classification* of claims and the separate classification of the trade claims might be valid if the trade creditors were to receive different treatment from Phoenix. Indeed, Greystone initial-

ly created a separate class of unsecured creditors that could be allowed to vote for the plan by the promise to pay their remaining claims in full *outside the plan*. Greystone then changed course and eliminated its promise. Because there is no separate treatment of the trade creditors in this case, we reject Greystone's "realities of business" argument.

Even if Greystone's Plan had treated the trade creditors differently from Phoenix, the classification scheme here is still improper. At the confirmation hearing, none of the Debtor's witnesses offered any reason for classifying the trade debt separately from Phoenix's unsecured deficiency claim. There is no evidence in the record of a limited market in Austin for trade goods and services. Nor is there any evidence that Greystone would be unable to obtain any of the trade services if the trade creditors did not receive preferential treatment under the Plan. Thus, the bankruptcy court's finding that there were good business reasons for separate classification is without support in the record and

must be set aside as clearly erroneous.[7]

Phoenix's unsecured deficiency claim approximates $3,500,000, while the claims of the unsecured trade creditors who voted to accept the Plan total less than $10,000. Greystone's classification scheme, which effectively disenfranchised Phoenix's Code-created deficiency claim, is sanctioned neither by the Code nor by case law. The lower courts erred in approving it.

III.

As a fall-back position, Greystone argues that the office-building tenants constitute an impaired class

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[7] Two standards of appellate review apply to the debtor's classification of claims. Issues such as the similarity in priority and legal attributes and the ultimate question whether treatment in the same or separate classes is necessary, are legal issues reviewable by our court *de novo*. *See* n. 5 *supra*. Whether there were any good business reasons to support the debtor's separate classification of claims is a question of fact.

whose votes for Greystone's Plan should have been considered for purposes of satisfying the pre-condition of cramdown that there be one assenting, impaired class. The bankruptcy court held that the tenants were not an impaired class and could not vote on the Plan because Greystone had assumed their leases. The district court disagreed and held that despite the Debtor's assumption of the leases, the tenants could be counted as an impaired accepting class. Phoenix argues this was error.

A debtor in Chapter 11 must either assume or reject its leases with third parties. 11 U.S.C. § 365. If the debtor does neither, the leases continue in effect and the lessees have no provable claim against the bankruptcy estate. *See Matter of Whitcomb & Keller Mortgage Co.*, 715 F.2d 375, 378-79 (7th Cir.1983); *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1352 (9th Cir.1983). Under the Code, only creditors are entitled to vote on a plan of reorganization. *See* 11 U.S.C. § 1126(c). A party to a lease is considered a "creditor" who is

allowed to vote, 11 U.S.C. § 1126(c), only when the party has a claim against the estate that arises from *rejection* of a lease. *In re Perido Motel Group, Inc.*, 101 B.R. 289, 293-94 (Bankr.N.D.Ala. 1989). If, however, the debtor expressly assumes a lease, the lessee has no "claim" against the debtor under § 1126a). See 11 U.S.C. § § 365(g), 502(g). The rights created by assumption of the lease constitute a post-petition administration claim under section 503(b)(1)(A) of the Code. *LJC Corp. v. Boyle*, 768 F.2d 1489, 1494 n. 6 (D.C.Cir. 1985). The holder of such a claim is not entitled to vote on a plan of reorganization. 11 U.S.C. § 1126(a); *In re Distrigas Corp.* 66 B.R. 382, 385-86 (Bankr.D.Mass.1986).

Here, Greystone never rejected its leases with the tenants. There is thus no support for the assertion that the tenants' "claims" entitled them to vote on Greystone's Plan. The district court erred in alternatively permitting confirmation of the Plan based on the tenants' affirmative votes.

Although we must remand simply because the

Greystone Plan mis-classified creditors' claims, it remains possible that Greystone will propose another plan incorporating, as did this one, the "exception" to the absolute priority rule. For the sake of judicial economy, we consider that possibility next.

IV.

Greystone's Plan relied upon the "new value exception" to the "absolute priority rule" to justify retaining ownership of the office building notwithstanding the plan's write-down of over 33%, or $3.5 million, of its debt to Phoenix. Outside the bankruptcy, such a result would be unthinkable, for Phoenix could have foreclosed and taken back its building for better or worse. Whether current bankruptcy law permits this egregious alteration of

rights without the secured creditor's consent has generated considerable controversy.[8] The lower courts held in favor of Greystone. We do not.

On its face, the Code does not appear to allow the equity owners of a bankrupt enterprise, or any junior creditors for that matter, to retain or obtain

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[8] In *In Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 108 S.Ct. 963, 967, n. 3, 99 L.Ed.2d 169 (1988), the Supreme Court expressly declined to rule on whether a "new value exception" to the absolute priority rule survived enactment of the Bankruptcy Code. The circuit courts are divided. *See, e.g., Kham & Nate's Shoes No. 2 v. First Bank*, 908 F.2d 1351 (7th Cir. 1990)(dicta)(questioning continued vitality of absolute priority rule); *In re Anderson*, 913 F.2d 530, 532-33 (8th Cir. 1990)(exception exists); *In re U.S. Truck Co.*, 800 F.2d 581, 587-88 (6th Cir. 1986). Bankruptcy courts have been sharply divided on the issue. *Compare In re Outlook/Century, Ltd.*, 127 B.R. 650, 656 (Bankr.N.D.Cal. 1991) and *In re Lumber Exchange Ltd. Partnership*, 125 B.R. 1000 (Bankr.Minn. 1991)(no new value exception), *with In re Sawmill Hydraulics, Inc.*, 72 B.R. 454, 456 n. 1 (Bankr.C.D.Ill.1987).

ownership and control of the debtor without the appropriate consent of senior creditors. This "absolute priority rule" is codified at 11 U.S.C. § 1129(b)(2)(B) as a definition of the "fair and equitable" standard for plan confirmation. Thus, the holder of any claim or interest that is junior to the claims of an unsecured class may not receive any property on account of its claim or interest until the senior claims are repaid in full. *Id.* It is undisputed that the right to run the reorganized business is property. *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 108 S.Ct.963, 969, 99 L.Ed.2d 169 (1988). The purpose of this section is to stratify creditors and equity interests so that a cramdown, or nonconsensual, plan will not redistribute a dissenting creditor's property rights to those with a junior right or interest in the debtor. Such a result would be neither fair nor equitable. *In re Greystone III*, 102 B.R. 574.

It was Greystone's burden to demonstrate how its owners' offer to infuse $500,000.00 into the debtor, paying off only a tiny fraction of Phoenix's deficien-

cy claim, satisfied the absolute priority rule. Greystone's argument proceeds in four phases. First, before adoption of the Bankruptcy Code the term "fair and equitable" had an established meaning that, under certain circumstances, allowed a deviation from the absolute priority rule if equity owners agreed to put cash into the company in exchange for an appropriate ownership interest. *See, e.g., Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 121-22, 60 S.Ct. 1, 10-11, 84 L.Ed.110 (1939)(dictum). Second, because the Code did not specifically overrule the prior judicial understanding of the fair and equitable standard, it must have incorporated that standard by including the "new value exception" in § 1129(b)(2)(B). Third, if § 1129(b)(2)(B) does not specifically codify the "new value exception," it represents only a partial definition of "fair and equitable" that leaves room for one. Fourth, Greystone's offer of $500,000 satisfies the new value exception.

With due respect to the ingenuity of Greystone's statutory construction agreement, we feel com-

pelled nevertheless to paraphrase Gertrude Stein: "There is no there there." It is not obvious, for instance, that the *Case* "new value exception" is meaningful in the context of Chapter 11's reorganization provisions, which differ markedly from the prior law. When *Case* was decided, the unanimous consent of all creditor classes was required in addition to a fair and equitable plan conforming to the absolute priority rule. *Case* 308 U.S. at 114 n. 6, 60 S.Ct. 6, n. 6. The 1978 Bankruptcy Code, however, permits less-than-unanimous acceptance of a creditor class to suffice even if the absolute priority rule is not satisfied and alternatively specifies conditions for cramdown plans. 11 U.S.C. § 1129(a), 1129(b)(2). This increased flexibility arguably renders the *Case* exception unnecessary and is certainly a significant distinction from the statutory background to that decision. *In re Outlook/Century Ltd., supra.*

Greystone's efforts to parse the statutory language for evidence of incorporation of the "new value exception" are similarly unpersuasive. Greystone

relies on two phrases in § 1129(b)(2). It is contended that by defining the "fair and equitable standard" to "include the following requirements," the definition is demonstrably incomplete, leaving implicit room for a new value exception. This seems unlikely, because the quoted phrase sets a minimum standard for a fair and equitable plan that may be confirmed over creditor objections. *Matter D & F Construction, Inc.*, 865 F.2d 673, 675 (5th Cir. 1989). The "new value exception," by contrast, dilutes the minimum requirement.

Alternatively, Greystone focuses on the condition in § 1129(b)(2)(B)(ii) that a junior claim or interest may not receive or retain property on account of its interest until more senior parties are fully satisfied. This argument holds that if "old equity" infuses new money into the debtor, it is not retaining its ownership "on account of" its old equity status. This is mere wordplay, because Greystone intends to prevent creditors from acceding to ownership of the property on account of Greystone's unique status as an old equity contributor to the plan.

More specifically, Greystone desired to prevent a competitive auction of the property, at which Phoenix could credit bid, precisely because of Greystone's old equity status. Greystone cannot read the statutory language in such a self-serving way.

Greystone next contends that if the statute does not express or imply a new value exception, it merely intended to codify preexisting law and is not inconsistent with such law. This position attributes too little weight to the statutory language, which "we are to take...seriously even when it alters pre-Code practices." *Kham & Nate's Shoes No. 2 v. First Bank*, 908 F.2d 1351 (7th Cir.1990)(Easterbrook, J.), citing *Pennsylvania Dept. of Welfare v. Davenport*, 495 U.S. 552, 110 S.Ct. 2126, 21300-31, 109 L.Ed.2d 588 (1990). *Moreover, as Judge Eastbrook and others have observed, Congress clearly rejected a proposal by the Bankruptcy Commission to modify the absolute priority rule when it enacted the Code. See, e.g., Brudney, The Bankruptcy Commission's Pro-*

*posed "Modifications" of the Absolute Priority Rule*, 48 Am.Bankr.L.J. 305 (1974). *In Outlook/Century Ltd.*, *supra*. From this history one can infer that Congress acted knowledgeably in codifying a strict absolute priority rule. Such history also contradicts the suggestion that the "new value exception" is merely a "logical expansion" of the codified absolute priority rule, *In re Greystone III*, 102 B.R. at 574, because it was part of the pre-Code "fair and equitable" standard. Further, to the extent that these arguments advocate equitable variations from the absolute priority rule, they conflict with *Ahlers'* observation that "whatever equitable powers remain in he bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Ahlers, supra*, 485 U.S. at 206, 108 S.Ct. 968-69.

*In an amicus brief, a final reason suggested for applying the "new value exception" within the codified absolute priority rule is that the Code does not prohibit a cramdown reorganization plan that sells the debtor to its former equity owners, and the*

"new value exception" is necessary to rein in that potential force for self-dealing. We disagree with the assumption that the Code permits a nonconsensual plan to "sell" the debtor to its old equity owners. This flies in the face of the creditor control principal embodied in Chapter 11 and accepted by Ahlers.

> The Court of Appeals may well have believed that petitioners or other unsecured creditors would be better off if respondents' reorganization plan was confirmed. But that determination is for the creditors to make in the manner specified by the Code. 11 U.S.C. § 1126(c).

485 U.S. at 206, 108 S.Ct. 969.

Moreover, permitting the courts, pursuant to a "new value exception," rather than the creditors, under a strict absolute priority rule, to determine the conditions of former equity owners' participation in a reorganized debtor introduces an enormously complicating factor in a carefully balanced

bargaining structure. The proposed test for the "new value exception" is exceeding vague--requiring the infusion in (a) money or money's worth of (b) substantial (c) new value, (d) reasonably equivalent to the extent of old equity's proposed participation in the reorganized debtor, and (e) necessary to such reorganization. Amicus Brief of Prof. Warren, at 12. If these criteria are essentially factual, then each bankruptcy court can impose its freewheeling view of reorganization policy without fear of appellate reversal. Creditors and the debtor are left to guess, *not what each other's* "bottom line" *position is* for a consensual plan, *but rather what the particular court sees* as a "bottom line" cash contribution that will permit cramdown of an old equity plan under the "new value exception." It is dubious to suppose that courts will ordinarily possess superior foresight than the creditors themselves concerning the creditors' best interests. Here, for instance, Greystone owed Phoenix $3.5 million above the value of its collateral, yet the court, allowed it to pay $140,000 on that obligation

and retain complete ownership for a half-million dollar capital infusion. Meanwhile, Greystone remains obligated for only about $5.8 million on what was originally an $8.8 million loan. If the bankruptcy courts may implement "new value," nonconsensual reorganization plans governed by such amorphous standards, one wonders why Congress bothered to frame elaborate ground rules for achieving consensual plans. Negotiations between creditors and the debtor against such a "new value exception" backdrop would be enormously skewed erode the utility of the creditors' votes.

Neither in the Code's language, nor in the context of a previous, different reorganization law, nor in legislative history, nor in policy is there room for a "new value exception" to the absolute priority rule now defined by § 1129(b)(2)(B).

Because of this conclusion, it is unnecessary to determine whether the lower courts properly applied a "new value exception" to the absolute priority rule. We note, however, that even though the

"standards" for that exception are most difficult to consider effectively on appeal, the bankruptcy court erred in refusing to consider Phoenix's proposed equity contribution plan along with that of former equity. There is no statutory or policy reason why the court should have arbitrarily rejected a competing bid by Phoenix to infuse equity into the debtor after the exclusivity period lapsed. See 11 U.S.C. § 1121.

V.

For the foregoing reasons, the judgment of the district court affirming the bankruptcy court's confirmation of Greystone's plan of reorganization is REVERSED. The case is REMANDED for proceedings consistent with this opinion.

In the Matter of

GREYSTONE III JOINT VENTURE, Debtor.

PHOENIX MUTUAL LIFE INSURANCE COMPANY,

Appellant,

v.

GREYSTONE III JOINT VENTURE, Appellee.

Civ. A. Nos. A-89-CA-667, A-89-CA-842.

United States District Court,
W.D. Texas,
Austin Division.
July 31, 1990.

ORDER

WALTER S. SMITH, Jr., District Judge.

This is an appeal from a final order of the United States Bankruptcy Court for the Western District of Texas, Austin Division (Clark, J.).

I. Statement of Issues and Standard of Review

Phoenix Mutual Life Insurance Company ("Phoenix Mutual" or the "Appellant") presents the following issues:

1. Did the Bankruptcy Court err in permitting the Debtor to separately classify the unsecured trade creditors' claims from Phoenix Mutual's

unsecured deficiency claim?

2. Did the Bankruptcy Court err in holding that the Modified Plan does not violate the absolute priority rule?

3. Did the Bankruptcy Court err in confirming the Modified Plan without requiring new disclosure to the Trade Creditor Class?

Under Bankruptcy Rules 7052 and 8013, the Bankruptcy Judge's findings of fact must be upheld on appeal unless "clearly erroneous." *In re Beker Industries Corp.*, 89 B.R. 336, 342 n. 5 (S.D.N.Y.1988); *In re Silver*, 46 B.R. 772 (D.Col.1985). However, the Bankruptcy Judge's conclusions of law are reviewed de novo. *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303 (5th Cir.1985).

II. Statement of Facts and Statement of the Case

Greystone III Joint Venture (the "Debtor" or the "Appellee") is a Texas joint venture composed of Gerald D. Kucera, Greystone Bank Building Partnership and Greystone III, Ltd. The Debtor was formed on August 30, 1983 for the purpose of

developing an office building located in Austin, Texas. This project is the Debtor's primary asset.

Phoenix Mutual is the owner and holder of a promissory note (the "Note") in the original principal amount of $8.8 million, executed by the Debtor, dated September 17, 1985, and due to Phoenix Mutual. The Note is secured by a deed of trust mortgage and assignment of rents covering the Project.

On April 4, 1988, the Debtor filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. On June 13, 1988, the Debtor filed a Plan of Reorganization and a Disclosure Statement. On September 7, 1988, the Debtor filed its First Amended Plan of Reorganization and its First Amended Disclosure Statement. On September 28, 1988, the Debtor filed its Second Amended Plan of Reorganization (the "Plan") and its Second Amended Disclosure Statement (the "Disclosure Statement"). Also on September 28, 1988, the Bankruptcy Court conducted a hearing at which the Disclosure Statement was approved. On

October 31, 1988, the Bankruptcy Court conducted a hearing on the propriety of the classification of claims under the Plan and on the valuation of Phoenix Mutual's secured claim under Section 506(a) of the Code. The aggregate amount of prepetition indebtedness owed to Phoenix Mutual totals $9,300,773.60. The Court set the value of the project at $5,825,000 for purposes of confirmation of the Plan. Therefore, pursuant to 11 U.S.C. ss 506(a) and 1111(b), Phoenix Mutual has a secured claim of $5,825,000.00 and an unsecured claim of approximately $3,500,000.00.

The Court approved the classification scheme of the Plan, except that the Court required that two classes of unsecured creditors, Classes 5 and 6, be considered together for balloting. Objections to the Plan were filed by Phoenix Mutual and the United States Trustee ("Trustee").

On January 27, 1989, the Bankruptcy Court held a confirmation hearing on the Plan, at which the Debtor orally modified the Plan to satisfy certain objections of Phoenix Mutual and the Trustee and

to clarify the Plan.

As previously noted, Phoenix Mutual's claims were placed within different classifications under the Plan, part secured and part unsecured. The secured claim of Phoenix Mutual is contained in Class 4, and provides that Phoenix Mutual would receive the value of its secured claim at a market interest rate in 360 monthly installments. The Court, as previously noted, found the amount of the secured claim to be $5,825,000, and the parties stipulated that 11 percent was a market interest rate. At the confirmation hearing, the Plan was modified to provide for a balloon payment after ten years.

The Plan confirmed by the Bankruptcy Judge separately classifies but identically treats the unsecured claims of Phoenix Mutual and the unsecured claims of trade creditors whose claims aggregate less than $10,000 ("Classes 5 and 6" or the "Trade Creditor Class"). The unsecured claim of Phoenix Mutual was placed into Class 7, as a non-recourse deficiency claim. The Plan provided

that Phoenix Mutual would receive "$200,000 (or 3.82%)" in cash on the effective date of the Plan. The Plan further provides that Class 5/6 would be paid 3.82 percent of their claims in cash upon the effective date of the Plan.

Phoenix Mutual rejected the Plan as both a secured and an unsecured creditor and did not elect treatment under 11 U.S.C. s 1111(b)(2). The Trade Creditor Class accepted the Plan. At the Confirmation Hearing, a representative of Phoenix Mutual testified that Phoenix Mutual was willing to fund a reorganization of the Debtor that would pay all unsecured claims in full. The Bankruptcy Judge refused to permit Phoenix Mutual to file its plan of reorganization for the Debtor.

On June 6, 1989, the Bankruptcy Court entered its Decision on Confirmation of Debtor's Second Amended Plan of Reorganization, as modified, overruling Phoenix Mutual's objection and confirming the modified plan using the "cram down" provisions of the Code. An Order of Confirmation was entered on August 8, 1989. It is from this

confirmation that Phoenix Mutual appeals.

## III. Discussion

A. Classification of Claims. The Appellant argues that the Bankruptcy Court erred in separating Phoenix Mutual's unsecured deficiency claim from that of the claims of the other unsecured trade creditors, asserting that there should have been only one class of unsecured claims allowed under the Plan.

Sections 1122 and 1123 of the Code require that a plan of reorganization designate classes of claims. Section 1123 provides in pertinent part:

(a) [A] plan shall--

(1) designate, subject to section 1122 of this title, classes of claims, other than claims of a kind specified in section 507(a)(1), 507(a)(2), or 507(a)(7) of this title, and classes of interests; ....

The Code expressly contemplates multiple classes of claims. Section 1122 gives the Debtor substantial freedom to establish classes of claims and provides:

*(a) Except as provided in Subsection (b) of this Section, a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.*

(b) A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.

The manner in which claims are classified can impact confirmation of a plan.

A plan may be confirmed under Section 1129(a) of the Code if all classes of creditors accept the Plan by the requisite majorities and certain other requirements are satisfied. However, if all of the classes of creditors do not consent, a plan may be confirmed under Section 1129(b) of the Code, the so-called "cram down" section, if at least one impaired non-insider class of creditors votes to accept the plan and the other relevant standards of

*Sections 1129(a) and (b) are met. Only the classes of creditors whose rights are impaired under a plan of reorganization are entitled to vote to accept or reject the plan.* 11 U.S.C. s 1126. Voting on a plan is by the classes as established in the plan. A class accepts a plan when two-thirds in dollar amount and more than one-half in number of the creditors in such class vote to accept the plan. 11 U.S.C. s 1126(b).

Phoenix Mutual complains that the classification of its unsecured deficiency claim in a class separate from that of the unsecured trade creditors was structured purposely by the Debtor in order to nullify Phoenix Mutual's voting rights.

Section 1122 of the Code prohibits the grouping of dissimilar claims in the same class. Although Section 1122 does not specifically address the permissibility of placing similar claims in different classes, the pertinent legislative and case authority support such a flexible approach. See *In re U.S. Truck Co., Inc.*, 800 F.2d 581, 585 (6th Cir.1986).

Section 1122 allows a claim or inter-

> *est to be placed in a particular class only if such claim is substantially similar to the other claims or interests of such class. It does not require that similar classes be grouped together but merely that any group be homogeneous.*
>
> We find unpersuasive the current line of cases that hold Congress intended all unsecured claims of a similar nature to be grouped within one class unless a separate classification is established under Section 1122(b) A critical review of those cases attempts to create a statutory requirement where none exists and a reliance on pre-code law and Act statutory requirements.

*In re Ag Consultants Grain Division, Inc.*, 77 B.R. 665, 674 (Bankr.N.D.Ind.1987) (citations omitted). See also, *Matter of Jersey City Medical Center*, 817 F.2d 1055, 1060-61 (3rd Cir.1987); *Barnes v.*

*Whelan*, 689 F.2d 193, 201 (D.C.Cir.1982).

Of course "the classification in a plan should not do substantial violence to any claimant's interest." *Brinkley v. Chase Manhattan Mortgage and Realty Trust (Matter of LeBlanc)*, 622 F.2d 872, 879 (5th Cir.1980).

> The plan should not arbitrarily classify or discriminate against creditors. The fact that bankruptcy courts are courts of equity, however, allows exceptions to any strict rules of classifications of claims. A bankruptcy court can permit discrimination when the facts of the case justify it.

*Id.*

As noted, Phoenix Mutual claims that the classification was arranged for the purpose of denying its voting rights and, as such, is in violation of the "good faith" requirement of Section 1129(a)(3). So long as a plan is proposed with the legitimate and honest purpose to reorganize and is not otherwise prohibited by law, it is a plan which satisfies this

section. *Matter of Sun Country Development, Inc.*, 764 F.2d 406, 408 (5th Cir.1985).

The Bankruptcy Judge is, of course, in the best position to determine whether a particular classification is made in "good" or "bad" faith. In the present case, Judge Clark determined that the classification was proper because the legal "nature" of Phoenix Mutual's deficiency claim was different from that of the trade creditors, and that separate treatment was justified for good business reasons. These factual findings by the Bankruptcy Court are not clearly erroneous, nor has the Court discovered any error of law. Accordingly, the Appellant's first ground of error is overruled.

B. Absolute Priority Rule. As previously noted, two alternatives under the Code exist for the confirmation of a plan: confirmation under Section 1129(a) and confirmation under Section 1129(b). If an impaired class of claims votes to reject a plan, then the plan can only be confirmed pursuant to the provisions of Section 1129(b). See 11 U.S.C. s 1129(a)(8). In this regard, Section 1129(b) pro-

vides, in pertinent part:

> (b)(1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

The absolute priority rule

"provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan." The rule had its genesis in judicial construction of the

> undefined requirement of the early bankruptcy statute that reorganization plans be "fair and equitable." The rule has since gained express statutory force, and was incorporated into Chapter 11 of the Bankruptcy Code adopted in 1978. Under current law, no Chapter 11 reorganization plan can be confirmed over the creditors' legitimate objections (absent certain conditions not relevant here) if it fails to comply with the absolute priority rule.

*Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 108 S.Ct. 963, 967, 99 L.Ed.2d 169 (1988).

An exception to this rule developed which allowed confirmation of a reorganization plan over a creditor's objections when there has been an "infusion-of-'money-or-money's-worth' " by a junior interest holder. *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 60 S.Ct. 1, 84 L.Ed. 110 (1939). The Appellant argues that the Case exception has been

replaced by the 1978 amendments to the Code, specifically by Section 1129(b) which provides that an interest holder may not receive or retain any interest under a plan unless senior claimants are paid in full. The Appellant further argues that the continued vitality of the exception has been questioned by the Supreme Court in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988).

The Court agrees with the Bankruptcy Judge's determination that the Case exception remains vital. Neither the Code nor the Supreme Court has expressly repudiated the exception. The "fair and equitable" standard was incorporated into the Code when adopted in 1978. As cited above, Section 1129(b)(1) specifically refers to confirmation when the plan "does not discriminate unfairly, and is fair and equitable with respect to each of class of claims or interests that is impaired...."

The *Norwest* court expressly declined to make a determination as to whether the *Case* exception had been overruled by the 1978 passage of the Code.

*Norwest Bank Worthington v. Ahlers, supra*, 108 S.Ct. at 967, n. 3. The case authority prior to the *Norwest* opinion weighed in favor of the survival of the contribution exception. See *In re Green*, 98 B.R. 981 (9th Cir. BAP 1989); *Matter of Yasparro*, 100 B.R. 91 (Bankr.M.D.Fla.1989); *In re Snyder*, 99 B.R. 885 (Bankr.C.D.Ill.1989); *In re Henke*,, 90 B.R. 451 (Bankr.D.Mont.1988). *Contra*, *In re Winters*, 99 B.R. 658 (Bankr.W.D.Penn.1989).

Additionally, the equitable considerations that mandated the creation of this exception have not diminished. The rule is a logical extension of the notion that an equity reorganization should, in all respects, be "fair and equitable".

> Circumstances may exist where the success of an undertaking requires that new money be furnished and where the former stockholders are the only or more feasible source of the new capital. In such instances, the court may recognize as fair and equitable a plan which includes contributions of

> new money by stockholders, provided it satisfactorily appears that full recognition has been given to the value of the creditors' claims against the property.

*Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 121 n. 15, 60 S.Ct. 1, 10 n. 15, 84 L.Ed. 110, quoting *In re Dutch Woodcraft Shops*, 14 F.Supp. 467, 471, 30 Am.Bankr.Rep. 351 (D.C.Mich.1935).

As the Court has determined that the Bankruptcy Court did not err in applying the exception to the absolute priority rule, the question becomes whether the exception was correctly applied.

The *Case* exception serves the narrow purpose of affording the debtor the capital necessary to survive, and should be narrowly and precisely applied. There must be a rigorous showing that the cash infusion is necessary under the circumstances and is substantial. *Case v. Los Angeles Lumber Products Co.*, 308 U.S. at 121, 60 S.Ct. at 10. This is essential in order to assure that a debtor's equity

holders will not eviscerate the absolute priority rule by means of gratuitous, token cash infusions proposed primarily to "buy" cheap financing. *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific Railroad Co.*, 318 U.S. 523, 570, 63 S.Ct. 727, 751-52, 87 L.Ed. 959 (1943).

In the present case, the debtor's general partners proposed to advance $500,000 in additional cash. The Appellant does not dispute that the $500,000 cash infusion is substantial; rather, the Appellant argues it is not necessary. Appellant argues that the contribution of new money must be "essential to the success of the undertaking," and that to be essential, there must be no other sources of funding. Phoenix Mutual offered to advance $155,000 to pay off the unsecured creditors and complete tenant "finishing out" obligations, and argues, therefore, that the old interest holders' contribution is unnecessary.

The Court does not agree that there must be no other source of funding before the exception applies. The authority cited by Appellant does not

support its contention that the former stockholders be the only source from which additional funding is to come. In the *Case* opinion, as cited by Appellant, the Court notes:

> Circumstances may exist where the success of an undertaking requires that new money be furnished and where the former stockholder are the only or most feasible source of the new capital.

*Case*, 308 U.S. at 121, n. 15, 60 S.Ct. at 10, n. 15 (emphasis added). Similar language is used in the Seventh Circuit case cited by Appellant:

> ... if the creditors challenge a plan as not "fair and equitable" because the new capital is not necessary or the shareholder is not the most feasible source, then the court must make such a finding....

*Official Creditors' Committee v. Potter Material Service, Inc. (In re Potter Material Service, Inc.)*, 781

F.2d 99, 102 (7th Cir.1986). The opinion of the Bankruptcy Judge establishes that the most feasible source of funding was from the current owners of the partnership, rather than from Phoenix Mutual. This factual determination is not clearly erroneous, and Appellant's second ground of error is without merit.

C. Requirement of New Disclosure to the Trade Creditor Class. The Appellant asserts that the Bankruptcy Court erred in confirming the Modified Plan without requiring new disclosure to the Trade Creditor Class, apparently on the basis that the Trade Creditor Class was the only impaired class which could vote to accept the plan.

At the confirmation hearing, the Debtor orally offered to modify the Plan to remove the requirement of payment of the balance of the trade claims by the general partner within thirty days of confirmation. The effect of the modification was that the Modified Plan no longer promised that the Trade Creditor Class would be fully paid on the effective date and that the Trade Creditor Class would only

receive 3.82% on their claims under the Modified Plan. The Bankruptcy Judge allowed the oral modification and directed the Debtor to resolicit and provide disclosure of its Modified Plan, since the modification represented a "substantial modification" to the Plan. However, the opinion and order by the Bankruptcy Judge confirming the Plan does not refer to the requirement of resolicitation or new disclosure.

Section 1129(a) provides in pertinent part:

(a) The court shall confirm a plan--

(10) If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider.

Appellant argues that as Phoenix Mutual's claims are impaired, the Plan should not have been confirmed as the Debtor failed to obtain the acceptance of at least one impaired class of creditors, exclusive of insiders. The basis of Appellant's

argument is that Classes 4, 5, 6, and 7 were the only potential impaired classes for purposes of s 1129; that Phoenix Mutual was the only creditor in Classes 4 and 7 and rejected the Plan; and that Class 5/6 was not impaired within the meaning of s 1124.

Appellee asserts that Class 5/6 was impaired both before and after the modification and that it was not the only possible class which could have voted to accept the plan as Class 2 was also an impaired accepting class.

Appellee argues further that Appellant has no standing to assert this ground of error and that the Bankruptcy Judge's determination that no further disclosure was required was not clearly erroneous.

The record indicates that Class 2, the class of tenant security deposits, was also an impaired class of claims which did vote to accept the Plan. Class 2 was not an "artificial class", as alleged by Appellant, but had actual "claims" against the Debtor which were "impaired", as those terms are defined in the Bankruptcy Code. Section 101(4)

defines a claim as:

> (a) Right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured; or
>
> (b) Right to an equitable remedy for breach of performance if such breach give rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured.

Section 1124 defines when a claim is impaired, and provides, in pertinent part:

> Except as provided in section 1123(a)(4) of this title, a class of claims or interests is impaired under a plan unless, with respect to each claim or

interest of such class, the plan--

(1) leaves unaltered the legal, equitable, and contractual rights to which such claim or interests entitles the holder of such claim or interest;

(2) ..., or

(3) provides that, on the effective date of the plan, the holder of such claim or interest receives, on account of such claim or interest, cash equal to--

(A) with respect to a claim, the allowed amount of such claim....

Because the Plan guarantees only payment of 75 percent of the deposits paid to Debtor pre-petition, it does not leave unaltered the legal, equitable and contractual rights to which the deposit holders were entitled. Therefore, Class 2 was an impaired class within the meaning of the Code and the acceptance by Class 5/6 was unnecessary.

Additionally, the Bankruptcy Judge's implied finding that no further disclosure was required has not been established to have been clearly erroneous. Accordingly, Appellant's third ground is also without merit.

In light of the foregoing, it is ORDERED that the opinion of the Bankruptcy Court is hereby AFFIRMED.

/s/ Walter S. Smith, Jr.
WALTER S. SMITH, JR.
U. S. DISTRICT JUDGE

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE WESTERN DISTRICT OF TEXAS
AUSTIN DIVISION

| | | |
|---|---|---|
| IN RE: | § | |
| | § | |
| GREYSTONE | § | Bankruptcy |
| III | § | No. 88-10968 |
| JOINT VENTURE | § | (CHAPTER 11) |

ORDER OF CONFIRMATION ON DEBTOR'S SECOND AMENDED PLAN OF REORGANIZATION AS MODIFIED

Came on to be considered the Debtor's Second Amended Plan of Reorganization. The Debtor requested confirmation pursuant to 11 U.S.C. Section 1129(b). The Court having considered the evidence received and the argument of counsel finds this as follows:

1. The Debtor should be permitted to modify the Plan to delete the affirmative statement that general partners will satisfy the balance of trade debt claims, to reduce the term of repayment for the secured claim of Phoenix Mutual Life Insurance Company from 30 to 10 years with a balloon

payment at the end of 10 years, to provide for payment of U.S. Trustee fees under 28 U.S.C. § 1930(a)(6), and to delete the provision that the automatic stay will remain in effect after confirmation.

2. No further disclosure is required for these modifications.

3. A market interest rate for the Class 4 secured claim of Phoenix Mutual Life Insurance Company is 11%. The Court has previously valued the Class 4 claim at $5,825,000.00. The Court re-affirms this finding.

4. The Plan complies with the requirements of Section 1129(a), except for Section 1129(a)(8).

5. Counsel for the Debtor has filed his Certificate of Compliance With Bankruptcy Rule 3020, representing that the $500,000.00 cash infusion required by the Plan has been deposited in his Trust Account.

6. The Plan does not discriminate unfairly, is fair and equitable and thus complies with the requirements of Section 1129(b) with respect to each

class of claims or interests that is impaired under and has not accepted the Plan.

7. The Second Amended Plan of Reorganization as Modified should be confirmed.

8. The objections of Phoenix Mutual Life Insurance Company should be overruled.

9. The findings and conclusions contained in this Court's Decision on Confirmation are incorporated herein by reference.

It is, therefore, ORDERED, as follows:

1. The Debtor's Second Amended Plan of Reorganization is hereby modified as follows:

(a) The first sentence of the final paragraph on page 6 of the Second Amended Plan of Reorganization is modified to read:

> "The Class 4 allowed claim will be paid in one hundred twenty (120) equal monthly installments in an amount sufficient to repay the claim in three hundred and sixty (360) equal monthly installments beginning thirty (30) days after the effective date of the Plan; the

remaining balance shall be due and payable ten (10) years after the effective date of the Plan."

(b) The Plan's description of Classes 5 and 6 on pages 7 and 8 of the Second Amended Plan of Reorganization is modified to delete the language:

"and will honor its obligations within 30 days of confirmation".

(c) The Second Amended Plan of Reorganization is modified to provide that the Debtor-in-Possession shall pay all fees required under 28 U.S.C. Section 1930(a)(6) as they come due.

(d) The Second Amended Plan of Reorganization is modified to delete Art. II(A)(4) pertaining to the automatic stay.

2. The interest rate for the Class 4 secured claim shall be 11%. The amount of the Class 4 secured claim is $5,825,000.00.

3. The Second Amended Plan of Reorganization as modified, is hereby confirmed.

4. The objections of Phoenix Mutual Life Insur-

ance Company are hereby overruled.

SIGNED this 5th day of Aug., 1989.

/s/ Leif M. Clark
LEIF M. CLARK
U. S. BANKRUPTCY JUDGE

In re GREYSTONE III JOINT VENTURE, Debtor.
Bankruptcy No. 88-10968.
United States Bankruptcy Court,
W.D. Texas,
Austin Division.
June 6, 1989.

DECISION ON CONFIRMATION OF DEBTOR'S SECOND AMENDED PLAN AS MODIFIED

LEIF M. CLARK, Bankruptcy Judge.

CAME ON for hearing the Second Amended Plan of Reorganization of Debtor (as modified) together with the objection thereto by Phoenix Mutual Life Insurance Company ("Phoenix"). This decision focuses on those critical issues on which the parties focused at the hearing and in their post-submission briefs. The court finds that the balance of the findings required to confirm a plan under Section 1129 of the Bankruptcy Code have been successfully established by the debtor and will be set out in detail in the confirmation order.

I. THE FACTS AND POSTURE OF THE CASE

The plan proposes to pay both trade debt of approximately $10,000 and the Code-created deficiency claim of Phoenix Mutual (approxi-

mately $3,475,000) slightly over three (3) cents on the dollar. The plan also proposes to pay 1987 ad valorem taxes in excess of $108,000, and to assure payment of 75% of tenant security deposit claims. The partnership currently has on hand approximately $101,000, more than enough to pay off the trade in full, though nowhere near enough to pay even the remaining taxes, much less Phoenix' deficiency claim.

Absent bankruptcy, Phoenix is a nonrecourse creditor and would have no claim at all beyond its secured claim against either the partnership or its general partners. The trade debt and the tenants, on the other hand, have recourse under Texas law against both the partnership and the general partners, and the plan does not purport to restrict or eliminate that recourse. Texas Uniform Partnership Act, Tex.Rev.Civ.Stat.Ann., Art. 6132b, s 40 (West pamphl. ed. 1988); see *Republic Supply Co. v. Shoaf*, 815 F.2d 1046 (5th Cir.1987) (plan's discharge of nondebtor entity withstood collateral attack under principles of res judicata where credi-

tor failed to timely object to plan). The debtor's partners intend to retain their equity interest in the venture with a capital infusion of $500,000, to be used both to fund payments to creditors and for future operations.

All creditors other than Phoenix have supported the plan. The plan was amended at the confirmation hearing to delete the affirmative statement that general partners would satisfy the balance of trade debt claims [1] and to reduce the term of repayment for Phoenix' secured claim from thirty to ten years, with a balloon at the end.

Phoenix still objects to the plan, contending that (1) the plan is either not proposed in good faith

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[1] The Debtor urged that the statement in the plan was intended to be nothing more than a restatement of Texas law. In fact, the general partners were not parties to the plan, other than in their capacity as equity investors, so the plan could not purport to bind them to an obligation to which they had not affirmatively consented anyway.

because the plan improperly classifies the trade debt as a separate impaired class or, alternatively, unfairly discriminates by "artificially impairing" the trade debt and (2) the plan cannot be forced upon Phoenix over its objections anyway because it is not fair and equitable with respect to Phoenix' deficiency claim. The debtor responds that the Code contemplates flexibility in classification, so that making use of the tools afforded by the Code cannot, by definition, be anything other than good faith as that term is used in Section 1129(a)(3). The debtor adds, in the same vein, that its treatment of the trade is intended to come within the rule of law announced by this court in *In re Meadow Glen, Ltd.*, 87 B.R. 421, 425 (Bankr.W.D.Tex.1988), in order to avoid a finding that the plan "unfairly discriminates." Finally, the debtor argues that the capital infusion of $500,000 proposed by the partnership's partners brings the plan within the exception announced in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 60 S.Ct. 1, 84 L.Ed. 110 (1939).

## II. ANALYSIS OF THE LAW

Phoenix argues that this debtor's plan takes improper advantage of Chapter 11, and subverts the intent of Congress in the process. Phoenix complains that the plan impermissibly silences Phoenix, by putting the trade debt into a separate class which has enthusiastically accepted the plan. This, Phoenix urges, subverts the "clear intentions" of Congress in enacting Section 1129(a)(10). Meanwhile, the debtor's principals are "buying" their way back in ostensibly under the exception to the absolute priority rule announced in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 60 S.Ct. 1, 84 L.Ed. 110 (1939), undermining the "veto" which Phoenix believes Congress intended to confer on undersecured nonrecourse lenders by virtue of Section 1129(b)(2)(B).

According to Phoenix, the debtor has taken advantage of creative classification, then "artificially impaired" that class in order to give the debtor an accepting class, avoiding domination by Phoenix' Code-created deficiency claim. The cash infusion

meanwhile skirts the absolute priority rule of Section 1129(b)(2)(B) that the objecting unsecured class either be paid in full or that junior interests retain or get nothing under the plan. Phoenix is vociferous in urging that the debtor's tactics circumvent the structure of the Code. The argument presupposes, however, that Congress intend the secured lender in cases such as this to have the final say over whether a plan should be confirmed. That presupposition gives more credit to Congress and its intentions than Congress appears to be due, however.

A. An Historical Perspective on the Role Envisioned for Secured Creditors in Single-Asset Real Estate Cases under the Bankruptcy Code

Prior to the passage of the Bankruptcy Reform Act in 1978, single asset real estate debtors, employing Chapter XII of the Bankruptcy Act, could "write down" their secured debt while the market was low, then enjoy the appreciation realized in excess of the written-down mortgage when the market rebounded. See *Great National Life*

*Insurance Co. v. Pine Gate Associates, Ltd.*, 2 B.C.D. 1478 (Bankr.N.D.Ga.1976) (hereinafter *Pine Gate*). According to the *Pine Gate* court,

> Nowhere in Chapter XII is there any exclusion of the benefit of Chapter XII to a debtor having only one secured creditor. The history of the creation of Chapter XII, which was to provide a remedy to property owners to avoid foreclosure under distressed economic conditions indicates otherwise.... [T]he contract rights of a secured creditor in the property of which a debtor is the legal or equitable owner may be modified or altered even without the consent of such secured creditor so long as the secured creditor receives adequate protection under Section 461 to realize the value of its lien. Retention of property is the statutory scheme of Section 461(11)(c) and adequate protection, rather than

consent, of the secured creditor is its keystone.

Id. at 1487; see also *Matter of Accousti*, 2 B.C.D. 1093 (Bankr.D.Conn.1976); *Matter of Marietta Cobb Apartments*, 3 B.C.D. 720 (Bankr.S.D.N.Y.1977); *Matter of Hobson Pike Associates, Ltd.*, 3 B.C.D. 1205 (Bankr.N.D.Ga.1976).

These cases construing Chapter XII (which until the early 1970's had fallen into disuse) arose even as Congress was undertaking a major overhaul of the bankruptcy laws. See generally "*Report of the Commission on the Bankruptcy Laws of the United States*," H.R.Doc. No. 137, 93rd Cong, 1st Sess (1973). By 1977, the House had completed its final proposed draft of a new Bankruptcy Code, H.R. 8200, which combined former reorganization chapters X, XI, and XII into a single chapter (Chapter 11), optimistically designed to be flexible enough to meet all the needs for which the three chapters were created in the Chandler Act of 1938. 124 Cong Rec H11117, 95th Cong, 2d Sess (daily

ed. Sept. 28, 1978) (remarks of Rep. McClory). The House version adopted many of the recommendations of the Bankruptcy Commission, and took a liberal approach in its provisions which decidedly favored reorganization. H.R.Rep. No. 595, 95th Cong, 1st Sess 220 (1977), U.S.Code Cong. & Admin.News 1978, p. 5787. In its confirmation section, the House version permitted confirmation over the objections of dissenting secured creditors so long as their claim was essentially "adequately protected," (cf. 11 U.S.C. (repealed) s 861), and over the objections of dissenting impaired unsecured classes of creditors so long as no junior classes received property on account of their junior claims (a modified version of the Chandler Act's "fair and equitable" standard, codified and preserved in Chapter X of the Bankruptcy Act). H.R. 8200, s 1129, 95th Cong, 1st Sess (1977). Section 506(a) of the proposed bill defined a secured claim in terms of the value of the collateral securing the debt, as had Chapter XII of the Bankruptcy Act. Section 502, meanwhile, provided that claims

would be disallowed if unenforceable against the debtor for any reason. One such unenforceable claim would, of course, be a "deficiency" claim asserted by a nonrecourse lender. Under the House version, a plan could conceivably be confirmed even though no impaired class voted in favor of the plan, because there was no antecedent to current Section 1129(a)(10) in H.R. 8200. Under the House version, then, a Chapter XII-type reorganization would be permitted under new Chapter 11 as well. See *Matter of Marietta Cobb Apartments*, 3 B.C.D. 720 (Bankr.S.D.N.Y.1977); *Matter of Hobson Pike Associates, Ltd.*, 3 B.C.D. 1205 (Bankr.N.D.Ga.1976) (single asset real estate cases with only one creditor--the secured creditor--confirmed over the objections of that creditor).

By the next year, the Senate came up with its own, somewhat more conservative version of the Bankruptcy Code. S. 2266, 95th Cong, 2d Sess (1978). In its reorganization sections, the Senate version preserved many of the provisions of Chapter X of the Act, at least for publicly held compa-

nies. S. 2266, ss 1128, 1130, 95th Cong, 2d Sess (1978). It also contained a specific section severely restricting how real estate liens could be treated. [2]

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[2] (a) Notwithstanding any other provision of this chapter or section 506(a) of this title, the claim or interest of a creditor secured by a lien upon or security interest in property of the estate which is real estate, chattels real, leasehold estates in real property, or fixtures, to the extent that such claim or interest was incurred for the purchase or improvement of such property, may be altered or modified in the plan only in the following manner: (1) where a default in payment of an installment claim or interest is existing the claim or interest of the creditor may be reinstated whether or not reinstatement would be permitted under otherwise applicable law with all payments then in default to be amortized equally over the life of the reinstated loan at the same rate of interest; or (2) the claim or interest of the secured party may be extended as to payment on a reasonable, equitable and practicable basis as long as the value of the claim or interest as extended would be the indubitable equivalent of the claim or interest if reinstated under subsection (1)above.

Finally, in an evident reaction to these two then-recent cases, S. 2266 required that at least one class of creditors, exclusive of insiders, must have accepted the plan in order for it to be confirmed. S. 2266, s 1130(a)(12), 95th Cong, 2d Sess (1978).[3]

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S. 2266, s 1130(a), 95th Cong.2d Sess (1978).

[3] The two cases came out within a few weeks of each other in September 1977, while the Senate version was undergoing drafting. See *Matter of Marietta Cobb Apartments*, 3 B.C.D. 720 (Bankr.S.D.N.Y.1977); *Matter of Hobson Pike Associates, Ltd.*, 3 B.C.D. 1205 (Bankr.N.D.Ga.1976). In each case, the bankruptcy judge, construing Section 461(11) of Chapter XII of the Bankruptcy Act, found no prohibition on confirmation of a plan involving only one creditor, the secured creditor, over that creditor's objections, so long as the plan provisions themselves afforded adequate protection of the value of the secured creditor's lien interest. Both decisions were well-reasoned and correctly refuted the continuing application of a

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judicial gloss to the contrary that had its genesis in cases which predated changes to Chapter XII made in 1952. *Matter of Hobson Pike Associates, Ltd.*, 3 B.C.D. at 1211-1214; see In re Herweg, 119 F.2d 941 (7th Cir.1941); see also Dole, "*Judicial Gloss*," *The Chapter XII Cram-Down Provisions*, 82 Comm.L.J. 197-204 (June 1977). Both courts noted a congressional policy favoring cram-down as a way of achieving reorganization values over the objections of recalcitrant creditors whose property rights were satisfactorily addressed in the adequate protection scheme of the statute. *Matter of Marietta Cobb Apartments*, 3 B.C.D. at 724; *Matter of Hobson Pike Associates, Ltd.*, 3 B.C.D. at 1210. Finally, both cases underlined just how nonsensical it was for a secured creditor to complain that there were no other impaired creditors in favor of the arrangement. Said Judge Babbitt in *Marietta Cobb Apartments*, quoting a then-recent commentator:

> ... it is not terribly difficult for the enterprising real estate debtor to incur other creditor obligations, perhaps even resulting in secondary and mechanics or materialmen's liens on the

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> property. The reorganization plan can propose payment of all or part of these claims in cash, assuring the favorable vote of those classes.

*In re Marietta Cobb Apartments Co.*, 3 B.C.D. at 724, quoting Lifton, *Real Estate in Trouble*, 31 Bus.Law. 1927, 1968 (1976). Even more acerbic was Judge Norton in *Hobson Pike Associates*:

> The true design of ... Chapter XII is not whether there are creditors to accept the plan in writing, but whether the plan provides the necessary "adequate protection" ... ... Should the *Herweg* ... view prevail, contrary to the strong Chapter XII rehabilitation intent, that view would seem to offer an invitation to debtors and attorneys practicing in the bankruptcy field to create some secured or unsecured debt on the eve of the Chapter XII filing in order to acquire some creditor acceptance of the plan.... It has been observed by bankruptcy attorneys to this court that unsecured

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> debt ... is easy to produce just prior to filing if unsecured debt is a prerequisite to enjoyment by the debtor of the statutory privileges [of reorganization].... Such fabrication of unsecured debt to meet the criticism of *Herweg* ... would be difficult for courts to recognize, if indeed, to do so would defeat jurisdiction or remove availability to this debtor relief chapter [sic]....
>
> [H]ow many unsecured creditors and/or how much debt other than the secured debt must be found to assent in order to allow a plan to be confirmed? ... Will one creditor for a $1.00, $10.00, $100.00, $1,000.00 debt suffice to sustain the required acceptances? Must the accepting creditor class be significant in number and/or amount in comparison to the objecting creditor? If so, what amount, how many? Surely such a statutory construction is an unsatisfactory result not intended

The two versions thus represented two philosophically inconsistent positions insofar as how single asset real estate cases might fare under the Bankruptcy Code. The House version would have continued the rehabilitation-oriented policies of Chapter XII, while the Senate version apparently gave ear to the complaints of secured creditors who had been burned under that very chapter. Not until the floor managers for each bill met in conference was there any effort to reconcile the inconsistencies. Unfortunately, the legislative history is largely unilluminating as to what precisely transpired in those meetings, and we have only the comments of the floor managers in the Congressional Record to give any hint to their thinking on the subject.

What we do know is that Congress retained the House version's cram-down powers and rejected "as

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unnecessary" the restrictions on real estate lien treatment found in the Senate version, "in light of the protection given a secured creditor under Section 1129(b) of the House amendment." 124 Cong Rec H11115, 95th Cong, 2d Sess (daily ed. Sept. 28, 1978)(remarks of Rep. Edwards). [4] To mollify the concerns raised by secured creditors as a result of the Pine Gate decision, the floor manag-

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by Congress.

*Id.* at 1210, 1213-14.

[4] Congress ended up tilting in favor of the House version, a bent acknowledged by the Supreme Court subsequently:

> By permitting reorganization, Congress anticipated that the business could continue to provide jobs, to satisfy creditors' claims, and to produce a return for its owners. H.R.Rep. No. 95-595, p. 220 (1977). Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than 'if sold for scrap.' Ibid.

*United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203, 103

ers devised a new subsection (b) for Section 1111. This complicated little provision was designed to achieve two basic tasks. First of all, it gave undersecured nonrecourse creditors a Code-created deficiency claim, solely for use in Chapter 11 reorganizations, overriding the general provision in Section 506(a) which would otherwise allow nonrecourse secured creditors a claim only to the extent of the value of their collateral. See 11 U.S.C. s 506(a). Second, it allowed such secured creditors to "opt-out" of recourse treatment, in which case the plan would have to "allow" the secured claim in an amount equal to the amount of the value of secured creditor's debt, rather than the secured creditor's collateral. [5] Section 1111(b) thus gave

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S.Ct. 2309, 2312, 76 L.Ed.2d 515 (1983), quoted in M. Bienenstock, *Bankruptcy Reorganization*, p. 1 n. 2 (PLI 1987).

[5] Under the latter scenario, in a cram-down, the plan would have to allow the claim in an amount equal to the

the nonre-course lender both a voice and a choice. In the words of a respected commentator,

> Section 1111(b) protects the legitimate expectation of the secured lender that the bankruptcy laws will be used only as a shield to protect debtors and not as a sword to enrich debtors at the expense of secured creditors.

5 Collier on Bankruptcy, P 1111.02[1], p. 1111-14 et seq. (15th ed. 1985).

In addition to adding Section 1111(b), the conferees also tried to beef up Section 1129(b), expressly using the terms of art "fair and equitable" and "unfairly discriminates" in s 1129(b)(1). Each of these terms carried their own judicial baggage into the cram-down portion of Section 1129.

The floor managers also carried into the joint

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debt, but the payment stream used to pay the claim need only have a present value equal to the value of the property. Then, in the event of a post-confirmation default, the secured

draft the Senate's provision that at least one class of creditors, exclusive of insiders, would have to accept the plan before it could be confirmed. They did so without explanation or comment, and apparently without consideration of either that section's relationship or impact upon the cram-down provisions brought into the draft from the House version. [6]

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creditor would have full recourse against the collateral up to the amount of its debt, enjoying any appreciation in the value of the collateral since confirmation.

[6] Recall that the Senate version had the requirement of at least one accepting class even though it did not have a "cram-down" provision. Its inclusion first in the Senate version and ultimately in the final version as enacted is probably traceable to the then-recent decisions in *Hobson Pike* and *Marietta Cobb Apartments*, discussed supra, and not to any interplay with cram-down. See 5 Collier on Bankruptcy, P 1129.02[10], p. 1129-36.10 (15th ed. 1987). In floor remarks, the floor manager of the bill in the Senate com-

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mented with regard to the new cram-down provisions that

> Section 1129(b) is new. Together with section 1111(b) and section 1129(a)(7)(C), this section provides when a plan may be confirmed, notwithstanding the failure of an impaired class to accept the plan under section 1129(a)(8).

124 Cong Rec S17420, 95th Cong, 2d Sess (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini). In the context of these remarks, Section 1129(a)(10) is noticeable by its absence.

While the policy it serves is questionable and undoubtedly leads to unfortunate "gaming" on the part of debtors, Section 1129(a)(10) nonetheless clearly evinces an apparent belief on the part of Congress that the scenario played out in *Hobson Pike Associates* and *Marietta Cobb Apartments* (i.e., confirmation of a plan accepted by no one and over the objections of the only affected creditor) is not an appropriate use of the bankruptcy powers. For better or worse, therefore, unless some disinterested, impaired third class of claims (other than the debtor and the affected secured creditor) favors the

The conferees apparently gave no particular thought to the impact of Section 1122 on the cram-down provisions of the Code, not anticipating how so-called "creative classification" schemes might affect a debtor's ability to gain access to the cram-down powers. [7] Both versions of the draft enactment contained nearly identical provisions regarding classification, and the legislative history only confirms that Congress did not envision any par-

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proposed reorganization, reorganization under the Bankruptcy Code, no matter how salutary or equitable, will simply not be available to the debtor. See *Anderson Oaks (Phase I) Limited Partnership*, 77 B.R. 108, 111 (Bankr.W.D.Tex.1987).

Apart from overruling the odious result in *Hobson Pike Associates* and *Marietta Cobb Apartments*, however, Section 1129(a)(10) appears to serve no other function particularly related to cram-down. But see 5 Collier on Bankruptcy, P 1129.02[10] at p. 1129.36.10 (15th ed. 1987).

ticular restrictions on the creative use of the classification powers, other than that (1) dissimilar claims could not be forced into the same class and (2) an impaired and dissenting class could not be treated differently than another class of equal dignity. 11 U.S.C. ss 1122(a), 1129(b); H.R.Rep. No. 595, 95th Cong, 1st Sess 406, 414-15 (1977).

Congress thus adopted an unclear middle position on the question of single asset real estate cases in bankruptcy. It could have given secured creditors veto power over reorganizations had it enacted the Senate version. It could also have effectively gagged the secured creditor had it settled solely on the House version. Instead, Congress made sausage and, as a result, courts and practitioners are left with a reorganization chapter which, when applied to single asset real estate cases, is rife with inconsistencies.

For example, Section 1111(b) "ungags" the secured creditor by giving it an unsecured claim which the drafters no doubt contemplated would dominate the unsecured class, forcing a donny-

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brook at cram-down over whether the debtor could retain any interest in the estate without paying off the Code-created deficiency. By happenstance, that same deficiency claim will, in the usual real estate case, because it dominates the unsecured class, threaten the debtor's plan under Section 1129(a)(10). By equal happenstance, however, the flexibility of Section 1122 seems to permit the debtor to easily circumvent that pitfall by simply preserving, impairing, and separately classifying trade debt. See *Hobson Pike Associates, Ltd.*, 3 B.C.D. at 1213. The only limitation on that tactic apparent on the face of the Code is the requirement that, as between the trade and the deficiency claim, the plan not unfairly discriminate. A creditor "victimized" by such tactics will be quick to point to Section 1129(a)(3), which requires the plan to have been proposed "in good faith," but that position is tenable only if one first assumes that the purpose of Section 1129(a)(10) was to assist in preventing debtors from obtaining access to the cramdown provisions, an assumption which this

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court finds is suspect. As we shall see below, the "good faith" argument is undercut by the expansive and flexible classification and impairment sections of the Bankruptcy Code, the use of which will in most cases also satisfy the technical requirements of Section 1129(a)(10). If any purpose can be divined from the Code's structure, it is that, in real estate cases such as this, the ultimate confrontation will take place over whether the plan can satisfy the stringent requirements of cram-down imposed by Section 1129(b), not whether it can satisfy the hyper-technical (and largely impractical) requirements of Section 1129(a)(10). This court cannot find any particular congressional intent, either expressed or implied in Congress' sausage-making exercise, that compels this court to read together the various Code provisions in such a way as to confer on secured creditors in cases such as these the veto power for which Phoenix now lobbies.

By the same token, however, the debtor's powers are not unrestricted. We thus explore those restric-

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tions in light of this plan. We first look at the classification question, then examine the *Case* exception. If the classification and treatment scheme pass muster, we will then turn to whether the *Case* exception is available to overcome the absolute priority rule and, if so, whether it is available to this debtor in this case.

B. THE CLASSIFICATION QUESTION

1. The flexibility of classification permitted by Section 1122

Collier's advises that a debtor enjoys considerable flexibility in the manner in which it classifies claims:

> Since Congress obviously intended that the proponent of a plan have the flexibility to separately classify certain general unsecured claims and thereby leave such claims unimpaired if such treatment was advantageous to the debtor, the argument that all claims of the same legal nature must be included within one class is not persuasive.

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5 Collier on Bankruptcy, P 1122.04, p. 1122-18 (15th ed. 1985). Some cases since the Code's enactment have been less certain about that flexibility, however, often responding to factual scenarios which a given court found offensive or abusive. See *Granada Wines, Inc. v. New England Teamsters and Trucking Industry Pension Fund*, 748 F.2d 42 (1st Cir.1984); *In re S. & W Enterprise, Inc., 37 B.R. 153 (Bankr.N.D.Ill.1984); In re Mastercraft Record Plating, Inc.*, 32 B.R. 106, 108 (Bankr.S.D.N.Y.1983), *rev'd on other grounds*, 39 B.R. 654 (S.D.N.Y.1984); *In re Pine Lake Village Apartment Co.*, 19 B.R. 819, 831 (Bankr.S.D.N.Y. 1982). These cases condemn the practice of creating a separate class for a given group of unsecured creditors apart from other unsecured creditors, finding in the tactic an attempt to "gerrymander" in order to satisfy the "one accepting class" requirement of Section 1129(a)(10). [8] They support a more

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[7] Floor comments note the interplay of Sections 1111(b),

restrictive "read" of Section 1122 by relying on Act cases which construed Section 197 of the Bankruptcy Act. [9] See *In re Los Angeles Land & Investments, Ltd.*, 282 F.Supp. 448, 453 (D.Hawaii 1968), *aff'd*, 447 F.2d 1366 (9th Cir.1971); *In re Scherk v. Newton*, 152 F.2d 747 (10th Cir.1945). By their interpretation, these cases hold that all claims of similar legal status vis-a-vis their entitlement to

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1129 and 1124 (relating to what constitutes an impaired class), but make no reference to Section 1122. 124 Cong Rec H11103, 95th Cong, 2d Sess (daily ed. Sept. 28,1978) (remarks of Rep. Edwards).

[8] If nothing else, the practice and the uproar it has created bears out Judge Norton's criticism of imposing such a requirement as a precondition to confirmation. Matter of *Hobson Pike Associates, Ltd.*, 3 B.C.D. at 1213; see note 3, supra.

[9] That section, which was part of Chapter X, read as follows, in pertinent part:

> For the purposes of the plan and its accept-

estate assets must be placed within the same class. [10] These cases also point to the reference in the legislative history to a codification of "existing case law surrounding the classification of claims and equity securities." S.Rep. No. 989, 95th Cong, 2d Sess 118 (1978), U.S.Code Cong. & Admin.News 1978, p. 5904.

Other cases have criticized this rigid interpretation of Section 1122. The Sixth Circuit, for example, pointed out that both the legislative history

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> ance, the judge shall fix the division of creditors and stockholders into classes according to the nature of their respective claims and stock....
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> 11 U.S.C. (repealed) s 597 (1976).

[10] One concern of Act cases was the possibility that claimants with the claims of equal dignity against a particular item of property might be separately classified, thereby depriving one group of claimants of valuable lien rights. See *Seidel v. Palisades-on-the-Desplaines* (*In re Palisades-on-the-Desplaines*), 89 F.2d 214, 217 (7th Cir.1937) ("all creditors of

and prior case law are inconclusive because Section 1122 is the successor not only to former Section 197 (part of Chapter X under the Act) but also to former Section 351 (part of Chapter XI under the Act). *In re U.S. Truck Co., Inc.*, 800 F.2d 581, 585 (6th Cir.1986). The latter section states only that

> For the purposes of the arrangement and its acceptance, the court may fix the division of creditors into classes and, in the event of a controversy, the court shall after hearing upon notice summarily determine such controversy.

11 U.S.C. (repealed) s 751 (1976). Because under Chapter XI, only unsecured claims could be adjusted, former Section 351 opened the door to multiple classes of claims similar in legal nature. Section 1122 on its face did not incorporate the more restrictive language of former Section 197 and the Sixth Circuit found no reason to re-insert such a restriction just because of a passing reference in the legislative history. Id. at 586-87.

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Other circuits have agreed with the Sixth Circuit's conclusion. *Matter of Jersey City Medical Center*, 817 F.2d 1055, 1061 (3rd Cir.1987); *Hanson v. First State Bank of South Dakota, N.A.*, 828 F.2d 1310, 1313 (8th Cir.1987); see *Matter of LeBlanc*, 622 F.2d 872 (5th Cir.1980) (construing a Chapter XII Bankruptcy Act case); *In re AOV Industries, Inc.*, 792 F.2d 1140 (D.D.C.1986).

Other bankruptcy courts have also rejected a restrictive reading of Section 1122. See, e.g., *In re Ag Consultants Grain Div., Inc.*, 77 B.R. 665, 670-76 (Bankr.N.D.Ind.1987); *In re Northeast Dairy Coop Federation, Inc.*, 73 B.R. 239, 249 (Bankr.N.D.N.Y.1987); *In re Mason & Dixon Lines, Inc.*, 63 B.R. 176, 181 (Bankr.M.D.N.C.1986); *In re Huckabee Auto Co.*, 33 B.R. 132, 137 (Bankr.M.D.Ga.1981). The court in *Ag Consultants* pointedly notes that even the reliance on Bankruptcy Act cases may be misplaced, as many of those cases did permit flexible classification, often at least in part because it would contribute to confirmation of the plan. See *In re Ogden Apart-*

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*ment Building Corp.*, 90 F.2d 712 (7th Cir.1937); see also *Seidel v. Palisades-on-the- Desplaines* (*in re Palisades-on-the-Desplaines*), 89 F.2d 214 (7th Cir.1937); *Brockett v. Winkle Terra Cotta Co.*, 81 F.2d 949 (8th Cir.1936); *In re Dudley v. Mealey*, 147 F.2d 268 (2d Cir.1945). At the very least, these Act cases placed their emphasis on the practicalities of a given case, with an eye toward favoring rehabilitation, and the *Ag Consultants* court wisely observed that even the oft-cited *Scherk v. Newton* case holds only that creditors of equal rank with claims against the same property should be placed in the same class, not that they must be. *In re Ag Consultants Grain Division, Inc.*, 77 B.R. at 674, citing *Scherk v. Newton*, 152 F.2d at 751. Finally, *Ag Consultants* reminds us that a court's first duty is to interpret a given statute as it is written,

> unless it is demonstrably at odds with the intentions of the statute's drafters. *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571, 102 S.Ct. 3245, 3250,

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73 L.Ed.2d 973 (1982).

> We find no ambiguity in 11 U.S.C. s 1122. Section 1122 allows a claim or interest to be placed in a particular class only if such claim is substantially similar to the other claims or interests of such class. It does not require that similar classes be grouped together but merely that any group be homogeneous. [citations omitted].

*Id.*

This court joins with *Ag Consultants* and the above-cited circuit court authority in finding

> unpersuasive the current line of cases that hold that Congress intended all unsecured claims of a similar nature to be grouped within one class.... A critical review [reveals that] those cases attempt[ ] to create a statutory requirement where none exists and a reliance on pre-Code law and Act statutory requirements.

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*Id.* at 675. Section 1122 authorizes flexibility in classification in furtherance of the rehabilitative intentions of Chapter 11.

2. The propriety of the classification scheme

The flexibility to "classify around" a secured creditor's Code-created deficiency claim is not unbridled, however. The Fifth Circuit has noted that

> As a general rule the classification in a plan should not do substantial violence to any claimant's interest. The plan should not arbitrarily classify or discriminate against creditors. The fact that bankruptcy courts are courts of equity, however, allows exceptions to any strict rules of classifications of claims. A bankruptcy court can permit discrimination when the facts of the case justify it.

*Brinkley v. Chase Manhattan Mortgage and Realty Trust (Matter of LeBlanc)*, 622 F.2d 872, 879 (5th Cir.1980).

Examining the propriety of the classification

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scheme focuses on the peculiar equities of each case, leading a court to exercise its equitable powers in the interests of forwarding the reorganization policy which underlies the Bankruptcy Code. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203, 103 S.Ct. 2309, 2312, 76 L.Ed.2d 515 (1982); H.R.Rep. No. 595, 95th Cong, 1st Sess 220 (1977).

Phoenix contends however that there must be a good reason to separately classify the trade in this case. Phoenix argues that the separate classification of the trade coupled with their unjustified impairment represents blatant "gerrymandering" which, if nothing else, violates the "good faith" requirement imposed by Section 1129(a)(3). Phoenix thus tries to bring itself within the facts of *Pine Lake Village, supra.* In that case, separate classification of a mortgage deficiency was not permitted because the sole purpose, according to the court, was to permit the plan to satisfy Section 1129(a)(10), which requires the acceptance of at least one class of impaired creditors. A single class

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of unsecured creditors there, as here, would have been dominated by the deficiency claim of the secured creditor. *Pine Lake Village Apartment Co., supra.* As we have indicated above, however, the underpinnings of *Pine Lake Village* are shaky. So also is the logic that Section 1129(a)(10) operates as a statutory gatekeeper to bar access to cram-down. [11] Finally, there is Fifth Circuit authority

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equal rank with claims against the same property should be placed in the same class"); *Scherk v. Newton*, 152 F.2d 747, 751 (10th Cir.1945) ("all creditors of equal rank with claims against the same property should be placed in the same class").

[11] As noted supra, there is nothing in the legislative history to indicate that Congress intended to "link" Section 1129(a)(10) with the cram-down powers. To the contrary, the provision was in the Senate version, which did not have a cram-down provision. See discussion supra at note 3. Congress' response to the cram-down power incorporated

that, so long as a plan is proposed with the legitimate and honest purpose to reorganize and is not otherwise prohibited by law, it is a plan which satisfies the "good faith" requirement of Section 1129(a)(3). *Matter of Sun Country Development, Inc.*, 764 F.2d 406, 408 (5th Cir.1985). [12]

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from the House bill was Section 1111(b), which merely assured that, if a debtor tried to force a plan onto a nonrecourse lender, the plan would have to pass muster under the modified absolute priority rules of Section 1129(b) both with respect to the secured claim (echoing Section 461(11) of the Bankruptcy Act) and to the Code-created unsecured claim (echoing the "fair and equitable" standard of Chapter X of the Bankruptcy Act). It seems not to have occurred to Congress that Section 1129(a)(10) might be used to bar access to the cram-down powers. Even if it had, the section's utility was undercut by the generous classification and

By the same token, however, recent cases have felt constrained to "draw the line" on the extent to which a plan can creatively classify creditors, though they have had some difficulty in articulating precisely why. For example, in *U.S. Truck*, the Sixth Circuit observed that

> In this case, U.S. Truck is using its classification powers to segregate dissenting (impaired) creditors from assenting (impaired) creditors (by putting the dissenters into a class or classes by themselves) and, thus, it is assured that at least one class of impaired creditors will vote for the plan and make it eligible for cram

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impairment provisions of Chapter 11: 11 U.S.C. ss 1122, 1123(a), 1124; see discussion infra.

[12] First, Brite's claim that the unsecured creditors' status was changed to effectuate the cram down does not go to whether the purpose of Sun Country's proposed plan is to reorganize is whether the plan has a reasonable hope of

> down consideration by the court. We agree with the Teamsters Committee that there must be some limit on a debtor's power to classify creditors in such a manner. The potential for abuse would be significant otherwise. Unless there is some requirement of keeping similar claims together, nothing would stand in the way of a debtor seeking out a few impaired creditors (or even one such creditor) who will vote for the plan and placing them in their own class.

*In re U.S. Truck Co., Inc.*, 800 F.2d 581, 586 (6th Cir.1986); *In re Jersey City Medical Center*, 817 F.2d 1055, 1061 (3rd Cir.1987) (citing *U.S. Truck*); *Hanson v. First Bank of South Dakota, N.A.*, 828 F.2d 1310, 1313 (8th Cir.1987) (finding no justification for separate classification in this case); *In re Northeast Dairy Coop Federation, Inc.*, 73 B.R. 239, 250 (Bankr.N.D.N.Y.1987).

If we take as a given that some independent

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reasonable grounds for separate classification must be found in order to authorize the proposed classification scheme, then one recognized rationale is a demonstrated economic need to treat certain otherwise similar claims differently. In *U.S. Truck Co., Inc.*, 800 F.2d 581, 586 (6th Cir.1986); *In re Jersey City Medical Center*, 817 F.2d 1055, 1061 (3rd Cir.1987); *In re Ag Consultants Grain Div., Inc.*, 77 B.R. 665, 676 (Bankr.N.D.Ind.1987). The legal character of a claim may also itself justify both disparate classification and treatment under the authority of a number of Act cases.

> Unsecured creditors may, under special circumstances, be divided into separate classes where the legal character of their claims is such as to accord them a status different from other unsecured creditors.

*In re Los Angeles Land of Investments, Ltd.*, 282 F.Supp. 448, 453 (D. Hawaii 1968), *aff'd*, 447 F.2d 1366 (9th Cir.1971); *Scherk v. Newton*, 152 F.2d 747, 751 (10th Cir. (1945) (classification is simply

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a method of recognizing difference in rights which call for difference in treatment); see also *Seidel v. Palisades-on-the-Desplaines (in re Palisades-on-the-Desplaines)*, 89 F.2d 214 (7th Cir.1937). The facts of this case justify disparate classification of the trade debt on both grounds.

First of all, trade creditors are not of equal legal status with Code-created deficiency claims. They have an independent claim against the general partners which the deficiency claim does not enjoy, because Section 1111(b) does not confer a comparable right. The "recourse claim" is only good against the debtor's estate in the Chapter 11 case. Section 1111(b) does not purport to create a claim cognizable under state partnership law against the partners.

The transformation of nonrecourse claims into recourse claims is for distribution purposes only in a Chapter 11 reorganization cases where the debtor has been given the power to retain encumbered property (over the objection of the secured creditor) for use in its plan of reorganization. "It

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was obviously not intended by according recourse [status] to non-recourse claims that the holders of these claims would be given any additional rights under state law." 3 Norton Bankr.L. & Prac. s 57.02

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> ... conversion of non-recourse claims to recourse claims is the "price" the debtor pays to use encumbered property in its reorganization over the objection of the secured creditor. If the property is voluntarily or involuntarily returned to the secured creditor, the non-recourse secured creditor is no longer entitled to this preferred status.

*Matter of DRW Property Co.*, 57 B.R. 987, 992, 993 (Bankr.N.D.Tex.1986).

Indeed, the estate in Chapter 11 has no claim against the partners, at least not via bankruptcy law. See *I-37 Gulf Ltd. Partnership*, 48 B.R. 647, 649 (Bankr.S.D.Tex.1985); see also 5 Collier on Bankruptcy P 1111.02[2], p. 1111- 22 (15th ed.

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1985). What is more, in a Chapter 7 case, while the estate has a claim against the partners, Phoenix' Code-created deficiency claim is no longer part of the estate's liabilities. 11 U.S.C. ss 723, 1111(b). The legal "nature" of Phoenix' deficiency claim is thus subtly different from that of the trade debt.

In this plan, the debtor "directs" the trade to the general partners, who are anticipated to pay their claims in satisfaction of their liability under the Texas Uniform Partnership Act. The trade are thus being treated somewhat differently, in recognition of their unique legal rights against the partners, rights which a Code-created deficiency claim can not enjoy.

Good business reasons also justify separate treatment, as the partnership and its partners need the trade to maintain good will for future operations. Trade debt simply does not extend credit to an entity such as this based on that entity's long-term ability to pay the debt back, but on the entity's short-term cash flow. If those expecta-

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tions are frustrated, creditors holding such debt have little recourse but to refrain from doing business with the enterprise.

The resulting negative reputation quickly spreads in the trade community, making it difficult to obtain services in the future on any but the most onerous terms. These simple realities of business more than justify separate classification of the trade debt from the obviously unrelated Code-created deficiency claim.

3. Classification and "artificial impairment."

We are still left with Phoenix' argument that the debtor could have paid the trade in full but left it to the partners instead, so that the debtor would have at least one impaired class to vote for the plan. Is this permitted? The Fifth Circuit's answer seems to be in the affirmative. *Matter of Sun Country Development* opined that taking advantage of the power of cram down is not ipso facto bad faith. 764 F.2d at 408. In that case, the debtor impaired a relatively small class of unsecured claims. The creditor there (as here) complained

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that there was no independent justification for that impairment other than to "open the gates" to the cramdown provisions. [13] The Fifth Circuit rejected

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success. Congress made the cram down available to debtors; use of it to carry out a reorganization cannot be bad faith.

*Id.* at 408 (emphasis added). Similar logic carries over to debtors' using the classification mechanism, which was made available to debtors by Congress, to carry out a reorganization.

[13] The case in *Sun Country* was filed prior to the 1984 amendments to the Bankruptcy Code which made explicit a judicial gloss that read in the word "impaired" into the requirement of one accepting class in Section 1129(a)(10). There was thus considerable doubt whether the judicial gloss was justified, in light of the express terms of the pre-1984 version of Section 1129(a)(10), and so some doubt whether the accepting class had to even vote, much less be impaired, due to the operation of Section 1126(f).

The debtor's first plan treated the unsecured creditors as

the notion that the debtor's tact was improper, given that the Code provisions were available and the debtor was simply using them. Id. at 408. What is more, nothing in Sections 1123 or 1124 either expressly or impliedly prohibits "intentional" impairment. See H.R.Rep. No. 595, 95th Cong, 1st Session 406, 408 (1977). [14] To the contrary, the

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unimpaired, but was later amended to give them a short-term note instead of cash on confirmation. Evidence taken by the district court confirmed that the debtor had an independent justification for the impairment, as the notes were subsequently redeemed at a discount after the debtor received its tax refund. The issue of so-called "unjustified" impairment was not therefore directly before the Circuit court.

[14] ... The plan must designate classes of claims and interests and specify, by class, the claims or interests that are unimpaired under the plan.... The plan must provide the same treatment for each claim or interest of a particular class ...

only "brake" on impairment appears to be the requirement in Section 1129(b) that the plan not "unfairly discriminate" against a dissenting class of creditors. *In re Meadow Glen, Ltd.*, 87 B.R. 421, 425 (Bankr.W.D.Tex.1988). We turn our attention, then, to that provision.

4. Classification and "unfair discrimination."

The argument that the debtor's tactic unfairly discriminates in all cases is not persuasive. See *In re Pine Lake Village Apartment, Co.*, 19 B.R. 819, 831 (Bankr.S.D.N.Y.1982); *In re Northeast Dairy Cooperative Federation, Inc.*, 73 B.R. 239, 249 (Bankr.N.D.N.Y.1987); *In re Meadow Glen, Ltd.*, 87 B.R. 421, 425 (Bankr.W.D.Tex.1988). The requirement that a plan not "unfairly discriminate" with respect to a dissenting class parallels the requirement that all creditors within a given class must be treated the same. Indeed, the phrase is a term of art, with a specialized mean

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H.R.Rep. No. 595, supra at 406 (discussing s 1123),

ing consistent with the operation of Section 1122(a). [15] In the words of Collier 's,

> Reducing discrimination to its bare essentials, a dissident class ... must ... receive treatment which allocates value to the class in a manner consistent with the treatment afforded to other classes with similar legal claims against the debtor.

5 Collier on Bankruptcy, P 1129.03[3], p. 1129-50 (15th ed. 1981); see H.R.Rep. No. 595, 95th Cong, 1st Sess 416-17 (1977); see also *In re Meadow Glen, Ltd.*, 87 B.R. 421, 425 (Bankr.W.D.Tex.1988). In this case, the debtor has

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U.S.Code Cong. & Admin.News 1978, p. 6362.

> This section is new. It is designed to indicate when contractual rights of creditors or interest holders are not materially affected. The section specifies three ways in which the plan may leave a claim or interest unimpaired.

*Id.* at 408 (discussing s 1124), U.S.Code Cong. & Admin.

assiduously accorded its trade debt precisely the same dividend as it has its Code-created deficiency claim and, in so doing, has satisfied the technical specifications of Section 1129(b) that the plan not "unfairly discriminate" against the dissenting class. [16] The two classes have the same relative legal priority of claim upon the estate's assets and are accorded the same percentage of payment out of those assets.

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News 1978, p. 6364.

[15] Cf. 11 U.S.C. s 1322(b)(1) (plan may designate a class of unsecured claims as provided in Section 1122, but may not discriminate unfairly against any class so designated). Chapter 13 combines the concept of unfair discrimination with the classification issue, a connection not directly made in Chapter 11 cases.

[16] The sponsors of the Code remarked that the proscription on unfair discrimination was merely included "for clarity," adding that the provisions of the House Report stated correctly the appropriate nterpretation of the phrase

Phoenix contends that, because the estate has more than enough in cash with which to pay off the trade, there is no just cause for failing to do so, so that the structure of the plan unfairly discriminates. In fact, however, it is the very proscription on unfair discrimination that mandates that the trade not be paid off, for nothing would then be left of those assets to pay the Code-created deficiency and the plan would prima facie "unfairly discriminate" against Phoenix:

> From the perspective of unsecured trade claims, there is no unfair discrimination as long as the total consideration given all other classes of equal rank does not exceed the amount that would result from an exact aliquot distribution.

H.R.Rep. No. 595 at 416, U.S.Code Cong. & Admin.News 1978, p. 6372. *In re Meadow Glen,*

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*Ltd.*, 87 B.R. 421, 425 (Bankr.W.D.Tex.1988). [1]

The upshot then is that this plan does not unfairly discriminate against Phoenix' Code-created deficiency claim, nor is the classification scheme inappropriate given the marked legal and economic differences between that claim and the trade debt. The court rejects the notion suggested first in *Meadow Glen* that this plan represents a case of "artificial impairment," as such a conclusion exceeds the intent of Congress in enacting the "unfair discrimination" language. If there is a rational justification for separate classification, the

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as used in this portion of the Bankruptcy Code. 124 Cong Rec H11104 (daily ed. Sept. 28, 1978) (remarks of Rep.Edwards); 124 Cong Rec S17420 (daily ed., Oct. 6, 1978) (remarks of Sen DeConcini). The House Report, in turn, states that a plan avoids unfair discrimination so long as it provides for "exact aliquot distribution."

H.R.Rep. No. 595 at 416, U.S.Code Cong. & Admin.News 1978, p. 6372.

[17] Phoenix' real frustration is that the plan deprives

debtor is entitled to exploit the parameters of the Code to get a plan confirmed. This court therefore holds that the plan passes muster with respect to its classification and treatment of Phoenix' Code-created deficiency claim.

C. THE CASE EXCEPTION

We turn now to whether the plan is "fair and equitable," i.e., whether the plan satisfies the absolute priority rule. Collier 's has commented gloomily that

> In the real estate limited partnership context, if the partnership's sole asset is a building which does not generate sufficient income to service debt, it is highly unlikely that the debtor can sustain its burden of proof under section 1129(b)(2)(B) that the debtor can provide full payment of the claims of unsecured creditors including the mortgagee's deficiency claims. Once it is clear that the debtor is unable to pay the unsecured deficiency claims in

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> full, the only way that the cram down powers can be successfully used is if the former equity interests are eliminated.

5 Collier on Bankruptcy, P 1111.02[2], p. 1111-20 (15th ed.1985).

The debtor argues that all is not lost, however, because the Supreme Court long ago recognized an "exception" to the absolute priority rule, giving it expression in a series of cases culminating in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 60 S.Ct. 1, 84 L.Ed. 110 (1939). Phoenix responds that the vitality of the exception under the current Bankruptcy Code was questioned in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988), and that this court should rule that the exception is no longer available to permit debtors to "buy" their way back in to their

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own cases. [18] If it is indeed no longer available, then this plan (and virtually all real estate bank-

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Phoenix of the veto to which it believes it is entitled by virtue of its large deficiency claim. As we have seen, however, that expectation is unwarranted. Congress gave creditors such as Phoenix the Code-created deficiency claim as an antidote to cram-down, not as a vaccine. The deficiency claim merely permits Phoenix to invoke the absolute priority rule, forcing the debtor's owners to negotiate a way to satisfy the claim or risk losing their ownership interest.

[18] In Ahlers, Justice White suggested in a footnote that

> our decision should not be taken as any comment on the continuing vitality of the *Los Angeles Lumber* exception--a question which has divided the lower courts since passage of the Code in 1978. Compare, e.g., *In re Sawmill Hydraulics, Inc.*, 72 BR 454, 456, and n. 1 (Bkrtcy CD Ill 1987) with, e.g., *In re Pine Village Apartment Co.*, 19 BR 819, 833 (Bkrtcy SDNY 1982).

Rather, we simply conclude that even if an

ruptcy cases in this part of Texas) must fail as a matter of law. If it survives, then the facts of this case must be tested against the exception to see if this case fits. If this case does not, then this case fails but others may follow with greater success.

1. The history and development of the "exception"

*Case* advised that a junior interest holder might retain an interest in the enterprise even though senior classes were not fully paid provided the junior interest holder had made a cash infusion which was both necessary under the circumstances and substantial.

*Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 121, 60 S.Ct. 1, 84 L.Ed. 110, 122 (1939). [19]

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> "infusion-of-'money-or-money's-worth' " exception to the absolute priority rule has survived .lm3

the enactment of s 1129(b), respondents' proposed contribution to the reorganization plan is inadequate to gain the benefit of this exception.

Case law had developed that promulgated a "fixed principle" that plans must be "fair and equitable," i.e., that equity reorganizations were required to adhere to an absolute priority in their payment scheme, enforceable as a matter of law by the court, regardless whether anyone else objected.

> [T]he stockholder's interest in the property is subordinate to the rights of creditors; first of secured and then of unsecured creditors.... [A]ny arrangement of the parties by which the subordinate rights and interests of stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation.

*Louisville Trust Co. v. Louisville, N.A. & C.R. Co.*, 174 U.S. 674, 19 S.Ct. 827, 43 L.Ed. 1130 (1899); see *Northern P.R. Co. v. Boyd*, 228 U.S. 482, 33 S.Ct. 554, 57 L.Ed. 931 (1913); *Kansas City Terminal R. Co. v. Central Union Trust Co.*, 271 U.S. 445, 46 S.Ct. 549, 70 L.Ed. 1028 (1926). This

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"fixed principle" was incorporated into Section 77B of the Bankruptcy Act by the inclusion of a requirement that plans be "fair and equitable," the term of art for the absolute priority rule. *Case, supra*, 308 U.S. at 119, 60 S.Ct. at 9. However, early cases also recognized that, due to practical considerations, the rule had to have an exception. In *Kansas City Terminal, supra*, the Court had noted that

> [W]hen necessary, [creditors] may be protected through other arrangements which distinctly recognize their equitable right to be preferred to stockholders against the full value of all property belonging to the debtor corporation, and afford each of them fair opportunity, measured by the existing circumstances, to avail himself of this right.
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> Generally, additional funds will be essential to the success of the under-

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> taking, and it may be impossible to obtain them unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them. In such or similar cases, the chancellor may exercise an informed discretion concerning the practical adjustment of the several rights.

*Kansas City Terminal R. Co. v. Central Union Trust Co.*, 271 U.S. at 454-55, 46 S.Ct. at 551-52. But for this exception, a perfectly sensible reorganization might founder for lack of capital infusion from the equity holders, who could hardly be expected to pump new money into a venture if they could not in the process retain an interest in the venture.

*Case* acknowledged the continuing vitality of the court-fashioned exception to the absolute priority rule:

> It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor....

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> Especially in [*Kansas City Terminal*] did this Court stress the necessity, at times, of seeking new money "essential to the success of the undertaking" from the old stockholders. Where that necessity exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made.

*Case v. Los Angeles Lumber Products Co.*, 308 U.S. at 121, 60 S.Ct. at 10. For the exception to lie, the circumstances of the case must first dictate the necessity of a capital infusion. Then, the participation given in return for the infusion must be "reasonably equivalent." The exception was thus carefully cabined, lest the absolute priority rule itself be eviscerated.

The Court went on to underscore the underlying importance of preserving the creditors' "full right of priority against the corporate assets," however:

> If that were not the test, then the

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> creditor's rights could be easily diluted by inadequate contributions by stockholders. To the extent of the inadequacy of their contributions the stockholders would be ... "in the position of mortgagor buying at his own sale."
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> In view of these considerations, we believe that to accord "the creditor his full right of priority against the corporate assets" where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or in moneys' worth, reasonably equivalent in view of all the circumstances to the participation of the stock holder.

*Case*, *supra* at 122, 60 S.Ct. at 10. *Case* thus reaffirms the paramount importance of preserving absolute priority, even though a new capital infusion might be required for the plan's success. The "exception" was thus carefully circumscribed.

2. The continuing vitality of the "exception"

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*Ahlers*'s inference that *Case* did not survive the enactment of the Bankruptcy Code can probably be traced to the Code's fundamental change in structure from the Bankruptcy Act. Under the Act, courts were required to enforce the absolute priority rule as a matter of law in Chapter X reorganizations. 11 U.S.C. (repealed) s 621(2) (1976). The Code, by contrast, permits consensual plans which need not comport with absolute priority, i.e., senior debt may voluntarily surrender rights to recovery out of the estate's assets to junior debt holders. 11 U.S.C. s 1129(a)(7), (8). Absolute priority is preserved as a prerequisite to confirmation only in the narrow circumstance of "cram-down," or confirmation over the objection of a dissenting class of creditors, and then only from the dissenting class down. 11 U.S.C. s 1129(b)(2)(B); H.R.Rep. No. 595, 95th Cong, 1st Sess 413 (1977). The retention of the "fair and equitable" standard in cram down situations serves the equitable end that a creditor class should only be forced to accept a plan over its objection upon assurance that it will

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not, in the process, be forced to surrender its rights to satisfaction of its claims out of the assets of the estate to junior interests. To reiterate the Supreme Court in *Boyd*, it would be neither fair nor equitable to visit such a result on classes of creditors whose claim on the assets of the enterprise is clearly superior. *Northern P.R. Co. v. Boyd*, 228 U.S. at 503, 33 S.Ct. at 559.

The *Case* exception does not undercut the protective equitable function of the absolute priority rule even as resurrected in Section 1129(b) of the Code. In fact, it is probably a misnomer to call it an exception at all. It is, rather and more accurately, a logical expansion on the notion that an equity reorganization should, in all respects, be "fair" and "equitable." The *Case* court quoted with approval an earlier bankruptcy case to that very effect:

> Circumstances may exist where the success of an undertaking requires that new money be furnished and where the former stockholders are the only or most feasible source of the new

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> capital. In such instances, the court may recognize as fair and equitable a plan which includes contributions of new money by stockholders, provided it satisfactorily appears that full recognition has been given to the value of the creditors' claims against the property.

*In re Dutch Woodcraft Shops*, 14 F.Supp 467, 471, 30 Am.Bankr.Rep. 351 (D.C.Mich.1935) (emphasis added), quoted at *Case*, *supra* at 308 U.S. 121 n. 15, 60 S.Ct. at 10 n. 15. An infusion of new capital may well be necessary to the success of the venture. To the extent that it is, and to the extent that persons willing to invest in the reorganized entity receive a participation in the enterprise commensurate with their investment, and no more, it cannot be said that the participation granted the investor renders the plan either unfair or inequitable. *Kansas City Terminal R. Co. v. Central Union Trust Co.*, 271 U.S. 445, 455, 46 S.Ct. 549, 70 L.Ed. 1028 (1926); *Case v. Los Angeles Lumber*

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*Products Co.*, 308 U.S. 106, 121-22, 60 S.Ct. 1, 10-11, 84 L.Ed. 110, 122-23 (1939). There is nothing about the structure of the Code that alters this fundamental recognition of the practicalities of all enterprises. It still takes cash to run any enterprise and the cash flow of the enterprise is frequently inadequate to the task. The same equitable considerations that motivated the recognition of the "exception" in *Kansas City Terminal*, and reaffirmed its vitality under Section 77B in Case, commend its preservation under the Bankruptcy Code, to assure that an overstrict application of the "fair and equitable" standard does not strangle the debtor and leave the reorganization stillborn.

This court thus holds that, notwithstanding the precautionary note in *Ahlers*, the Case "exception" is still good law, as it represents nothing more than an extension of the fair and equitable concept to embrace the need for new capital for the venture. To the extent the "fair and equitable"
concept has been brought forward into the Code, therefore, so also has the expansion on that con-

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cept enunciated in *Case*. There is nothing peculiar about real estate reorganization cases that suggest that the need for new capital in such cases is any less compelling than in any other venture, so Case should be available in such cases, provid.pa ed it is precisely applied. [20]

3. Applying the "exception"

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*Id.* at 485 U.S. at ---- n. 3, 108 S.Ct. at 966-67 n. 3, 99 L.Ed.2d at 177 n. 3.

[19] The actual cash infusion in *Case* was rejected because it failed the second prong of the test. Id. 308 U.S. at 121-22, 60 S.Ct. at 11, 84 L.Ed. at 123. First and foremost, the capital infusion was not cash. Second, the consideration retained by the stockholders was disproportionate relative to the infusion.

[20] It is fair to assume that Congress was aware of *Case* when it passed the Bankruptcy Code. That Congress did not expressly codify *Case*'s holding should be of no moment, as the term of art carried with it the judicial glosses that had been placed upon it. What does matter is that the Bankruptcy Code did not expressly repudiate *Case*. It is a time-hon-

When applying *Case* under the Bankruptcy Code, a court should first be sensitive to its antecedents. The exception serves the narrow purpose of affording the debtor the capital necessary to survive. It is not intended as a device by which pre-filing owners can buy their way back into the venture, much less preserve their ownership interest. Such a read would amount to a perversion of what Justice Douglas clearly intended to be a limited and narrow extension. Close attention must be paid not only to the letter of the exception but also to the spirit in which it was promulgated. Requiring a rigorous showing of both necessity and substantiality will assure that a debtor's equity holders will not eviscerate the absolute priority rule by means of gratuitous, token cash infusions proposed primarily to "buy" cheap financing. *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific Railroad Co.*, 318 U.S. 523, 570, 63 S.Ct. 727, 751, 87 L.Ed. 959, 1010 (1943).

If a cash infusion is not necessary to the reorganization effort, the debtor will have failed to have

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raised the predicate equitable concern that motivated resort to the exception in *Kansas City Terminal and Case* in the first place and the court should not allow the capital infusion and concomitant equity participation without the consent of the senior interests. We only entertain the *Case* extension to the absolute priority rule in those situations in which the enterprise needs the capital investment in the first place. Otherwise, the general concerns that animate the "fair and equitable" standard still predominate and prohibit use of the extension merely as a device to retain an interest in the venture.

If (and only if) the cash infusion is needed, it must be actual money or money's worth, paid not merely promised, and the participation accorded the equity interests in exchange for this cash infusion must be commensurate, reasonably equivalent. The equity interests will be allowed back into the venture only to the extent of their new contribution, in order to preserve creditors' full rights of priority in the estate's assets:

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> Whenever assessments are demanded, they must be adjusted with the purpose of according to the creditor his full right of priority against the corporate assets, so far as possible in the existing circumstances.

*Kansas City Terminal R. Co. v. Central Union Trust Co.*, 271 U.S. at 456, 46 S.Ct. at 552; *Northern P.R. Co. v. Boyd*, 228 U.S. at 504, 33 S.Ct. at 560.

With these preliminary considerations in mind, we turn to the facts and posture of this case.

a. The "necessity" prong

The debtor has enough cash to pay off all trade debt in full, but not the deficiency claim. Because of the strictures of Section 1129(b), which prohibit "unfair discrimination," the debtor cannot pay off the trade debt without jeopardizing the entire plan in the process. The debtor needs cash to pay the deficiency claim as well as the trade, in accordance with plan terms.

In answer to this need, the debtor's general partners propose to put in $500,000 in additional

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cash, some of which will be used to pay the debtor's portion of the trade, some of which will pay precisely the same percentage to Phoenix on its deficiency claim. [21] The debtor contends that the cash infusion is both necessary and substantial as those terms are used in *Case*, so that the plan should be found to be fair and equitable despite its technical noncompliance with Section 1129(b)(2)(B).

The office complex is well managed, with a good occupancy. The net operating income is close to, but not quite, sufficient to service the plan's debt. While the building is relatively new, it can anticipate a certain amount of maintenance in the future. The cash flow analyses of both appraisal experts as well as the projections of the debtor

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ored principle of statutory construction that legislators are presumed to be aware of judicial glosses placed on prior statutory enactments, and that subsequent amendments and codifications are presumed to have been carried into the new

confirm that, eventually, the debtor's anticipated cash flow will be insufficient to satisfy both debt service and the escrows needed for taxes and insurance. The total infusion of cash by the partners will cover these shortages and future needs, and will also pay off the claims of all but one class. Without this cash, the plan would not be feasible. See 11 U.S.C. s 1129(a)(11); see also *In re Murel*, 35 F.2d 941 (2d Cir.1935) (setting the standard for adequate protection of a secured creditor's interest in collateral over the life of a plan at "indubitable equivalence").

The cash will come from the current owners of the partnership, for which they are to receive 100% of the ownership interest in the venture. In the current economic climate, with banking institutions chastened by the extraordinary number of bank failures over the last five years, even well-run commercial real estate ventures should not expect to find working capital available from banks or savings and loan associations. Phoenix' own witness testified that there is no financing current-

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ly available for commercial properties in Texas, and the debtor's general partner confirmed that it has not been able to attract new equity outside of its existing partners, both general and limited.

Phoenix has indicated that it would be happy to advance $155,000 to pay off the unsecured creditors and complete tenant finish out obligations. It has not, however, indicated any willingness to fund future operations unless it can take over ownership of the property, a condition precedent inimical to the reorganization. It therefore does not represent a viable alternative source of working capital for the future of the entity. [22]

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statute unless expressly repudiated. The Bankruptcy Code did not repudiate *Case*, so the long-standing equitable expansion of the absolute priority rule should be presumed to still be good law.

[21] *Case* recognized that new money was commonly necessary in equity reorganizations not only to provide new work-

The proposed capital infusion from the existing owners of the partnership is, in this court's view, "essential to the success of the undertaking," and so satisfies the "necessity" predicate for the invocation of the capital infusion exception to the absolute priority rule. *Kansas City Terminal R. Co. v. Central Union Trust Co.*, 271 U.S. at 455, 46 S.Ct. at 551-52; *Case v. Los Angeles Lumber Products Co.*, 308 U.S. at 121, 60 S.Ct. at 10.

b. The "substantiality" prong

We turn, then, to the question of substantiality. As noted above, this part of the *Case* extension has

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ing capital but also to pay dissenting creditors. *Case, supra* at 308 U.S. 121 n. 15, 60 S.Ct. at 10 n.15.

[22] It is important to emphasize that, due to the nature of the *Case* capital infusion exception, it is inappropriate to approach the problem as though the ownership of the enterprise were up for sale. That is simply not the issue at all. Instead, the question is whether there is an available source of capital to fund the plan. By the time one gets to the *Case*

two facets.

First, the contribution must be "substantial" in the sense that it must be "money or money's worth." Items such as reputation, standing in the community, financial wherewithal, and management expertise, while perhaps important to the question of a plan's feasibility, have no place whatsoever in the calculus for what constitutes a "substantial contribution." *Case, supra*, 308 U.S. at 122, 60 S.Ct. at 10, *Ahlers*, supra, 485 U.S. at ---- n. 3, 108 S.Ct. at 966-67 n. 3, 99 L.Ed.2d at 177 n. 3.

Second, the participation or consideration accorded to those making the capital infusion must be commensurate with or reasonably equivalent to the capital infusion, to discourage current owners from buying up the venture for a relatively modest investment and to preserve the absolute priority rule. The essence of the absolute priority rule is that creditors have a prior right to the corporate assets which may not be undermined even in the interests of furthering the reorganization. Once

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bankruptcy is filed, the role of the equity interests in the continuation of the enterprise is fundamentally altered. In the words of the Court in *Case*, the equity interest owner, upon filing,

> ... invokes that jurisdiction risking all of the disadvantages which may flow to him as a consequence, as well as gaining all of the benefits. One of those disadvantages from the viewpoint of the debtor and its stockholders is the approval of a plan of reorganization which eliminates them completely.

*Case v. Los Angeles Lumber Products Co.*, 308 U.S. at 127, 60 S.Ct. at 12.

In this case, the debtor proposes to retain 100% of the ownership of the enterprise with a new equity infusion of $500,000. Is the proposed participation reasonably equivalent to the capital contribution? The question contains within itself a preliminary issue, how to measure "reasonable equivalence." The Supreme Court in *Northern P.R.*

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*Co. v. Boyd*, in evaluating whether existing equity might retain an interest in a railroad, commented that

> If the value of the road justified the issuance of stock in exchange for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control. In either event, it was a right of property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatsoever.

*Northern P.R. Co. v. Boyd*, 228 U.S. 482, 508, 33 S.Ct. 554, 561, 57 L.Ed. 931 (1913) (emphasis added). Again, the Supreme Court in *Kansas City Terminal* reiterated that

> when necessary, [creditors] may be protected through other arrangements which distinctly recognize their equitable right to be preferred to stock-

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> holders against the full value of all property belonging to the debtor corporation, and afford each of them fair opportunity, measured by the existing circumstances, to avail himself of this right.

*Kansas City Terminal R. Co. v. Central Union Trust Co.*, 271 U.S. at 454-55, 46 S.Ct. at 551-52 (emphasis added). Finally, the Supreme Court in *Ahlers* has recently reaffirmed that equity ownership has value, independent of the fair market value of the enterprise, for purposes of applying the absolute priority rule:

> We join with the overwhelming consensus of authority which has rejected this "no value" theory. Even where debts far exceed the current value of assets, a debtor who retains his equity interest in the enterprise retains "property." ... Indeed, even in a sole proprietorship, where "going concern" value may be minimal, there

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> may still be some value in the control of the enterprise; obviously, also at issue is the interest in potential future profits of a now-insolvent business. And while the Code itself does not define what "property" means as the term is used in s 1129(b), the relevant legislative history suggests that Congress' meaning was quite broad.
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> "'[P]roperty' includes both tangible and intangible property."

*See* H.R.Rep. No. 595 at 413.

*Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, ----, 108 S.Ct. 963, 969, 99 L.Ed.2d 169, 180 (1988) (emphasis added). We thus see that, in terms of the absolute priority rule, the enterprise first "belongs" to its unsecured creditors. [23]

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extension, one is already beyond whether the plan itself is otherwise proper. In other words, the issue of where to get the cash to make the plan work is not an opportunity to

By the same token, the capital infusion concept is grounded on the assumption that any investor, even a former owner, is entitled to compensation in exchange for investing new capital into the venture. *Case v. Los Angeles Lumber Products Co., supra*, 308 U.S. at 123, 60 S.Ct. at 11; *In re U.S. Truck Co.*, 800 F.2d 581, 588 (6th Cir.1986); *In re Potter Material Service, Inc.*, 781 F.2d 99, 103 (7th Cir.1986); *In re Toy & Sports Warehouse, Inc.*, 37 B.R. 141, 148 (Bankr.S.D.N.Y.1984); *In re Jartran, Inc.*, 44 B.R. 331, 367 et seq. (Bankr.N.D.Ill.1984).

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undermine the plan. Instead, if the plan fails, then another party in the case with standing may propose an alternative plan. At confirmation, the court is not at liberty to "conduct an auction" of the equity. The court's limited role is to decide whether the plan as proposed should or should not be confirmed. The consequences of that decision are for the parties to work out, not the court.

[23] Under the absolute priority rule as articulated in Case, claimants were entitled to have their relative values respected in full,

Many of these cases, including *U.S. Truck*, *Potter Material Service*, and *Jartran*, emphasize the risk associated with the investment, thereby justifying allowing a 100% ownership interest in exchange for a relatively modest capital infusion. [24]

The true balance needs to be struck between a recognition of this risk/reward analysis on the one hand and the creditors' entitlement to control over the venture by virtue of the operation absolute priority rule. Cases such as *Jartran*, *U.S. Truck*, and *Potter Material Service* do not give sufficient

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> according exactly to their nonbankruptcy entitlements. The fact that there was a going-concern surplus to the assets as a whole was irrelevant. This represented part of the value of the debtor's assets that the creditors had a right to over shareholders outside bankruptcy, and the absolute priority rule respected that right inside of bankruptcy.

Jackson, "*Reconsidering Reorganization*," *The Logic and Limits*

ear to the overriding function of the absolute priority rule, which is to assure that, to paraphrase *Boyd*, to the extent that the value of a given venture justifies the issuance of new equity in exchange for new capital, the creditors are entitled to the benefit of that value, whether it is present or prospective, for dividends or only for purposes of control. This is why the participation accorded the investor must be "reasonably equivalent." *Case v. Los Angeles Lumber Products Co.*, 308 U.S. at 122, 60 S.Ct. at 10. A court applying Case must evaluate not only the value of the equity in the enterprise being acquired by way of the capital infusion but also the "value" of senior rights threatened by the capital infusion. Note the comment of the Supreme Court in *Consolidated Rock Products* regarding how senior interests ought to be compensated in the face of a retention of values by junior interests:

> Thus, it is plain that while creditors may be given inferior grades of securities, their "superior rights" must be

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> recognized.... They must receive ... compensation for the senior rights they are to surrender. If they receive less than that full compensatory treatment, some of their property rights will be appropriated for the benefit of stockholders without compensation. That is not permissible.

*Consolidated Rock Products, Co. v. DuBois*, 312 U.S. 510, 528-29, 61 S.Ct. 675, 686, 85 L.Ed. 982, 995 (1941).

In order to evaluate whether the participation proposed to be afforded the equity investor is commensurate with the capital infusion, the bankruptcy court must be prepared to value all aspects of the enterprise. In some cases that will prove easier than in others. Compare *In re Potter Material Service, Inc.*, 781 F.2d at 103 with *In re Jartran, Inc.*, 44 B.R. at 367-79. These courts and others have adopted as their starting point *Consolidated Rock Products, Co. v. DuBois*, 312 U.S. 510, 61 S.Ct. 675, 85 L.Ed. 982 (1941). The Supreme

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Court there held that a "capitalization of prospective earnings" was essential in order to evaluate the relative distribution of property proposed:

> The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculations or disaster, and if the allocation of securities among the various claimants is to be fair and equitable. Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that

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> record is a reliable criterion of future performance. A sum of values based on physical factors and assigned to separate units of the property without regard to the earning capacity of the whole enterprise is plainly inadequate.

*Id.*, 312 U.S. at 526, 61 S.Ct. at 685, 85 L.Ed. at 993-94. Neither party presented any direct evidence on capitalized future net revenues, but the appraisals of both parties reflect, inter alia, a discounted cash flow analysis that supports the valuations of the allowed secured claim. Nothing remains in excess of that claim, apart from the $101,000 currently on hand, and the $500,000 to be invested. The debtor's general partner stated he did not expect a return on the investment, so much as a mitigation of the some one million dollars already invested in the project. He does not anticipate recovering $5.8 million (the amount of the allowed secured claim in the plan) in the near term, but believes that eventually, the market will recover and with it, the value of this property.

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Based upon projected revenues, it is not likely that the investors will recover on their investment for the ten year term of the plan.

Looking at the valuation of the enterprise itself as a going concern, relying on the discounted cash flows even of Phoenix' expert, the court finds that the investment justifies a 100% ownership of the enterprise, all other things being equal. See *In re Potter Material Service, Inc.*, 781 F.2d 99, 103 (7th Cir.1986); *In re Toy & Sports Warehouse, Inc.*, 37 B.R. 141, 148 (Bankr.S.D.N.Y.1984). The debtor's investors as "buying" the future risk of return, postponed in this case for ten years, for $500,000. Leaving that much money at risk for that long, in exchange for 100% of the reward at the end of that term is not at all unreasonable and full ownership under the circumstances is therefore justified given the long-term deferral of any reward for the investment relative to the risk of loss being shouldered.

We turn next to whether the senior interests will receive "compensatory treatment" consistent with

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the absolute priority rule. We must first decide just what senior rights, if any, are being "taken" by virtue of this proposed capital infusion. In this case, the "senior right" in question is the *Ahlers*-acknowledged right of an unsecured creditor class not being paid in full to control the enterprise to the exclusion of current ownership, a right otherwise conferred on Phoenix by operation of Section 1111(b), which gave Phoenix an unsecured claim entitled to control to the exclusion of junior interests under Section 1129(b)(2)(B).

It is not an easy task to evaluate the relative value of Phoenix' "loss of control" occasioned by the proposed capital infusion. [25] It is not even certain

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*of Bankruptcy Law*, 213 (Harvard University Press 1986).

[24] The *Jartran* case takes this concept to its logical (and perhaps impermissible) extreme, noting that, where a company is insolvent, any equity infusion at all will entitle the investor ipso facto to 100% of the equity of the company. *In re Jartran, Inc.*, 44 B.R. at 379 ("inasmuch as the share-

whether the value can be quantified, or that, if it can be, whether it need be compensated with money. Compensation "will be dependent on the facts and requirements of each case." *Consolidated Rock Products, Co. v. DuBois*, 312 U.S. at 529-30, 61 S.Ct. at 686-87, 85 L.Ed. at 995. [26] Spe-

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holders' equity is valueless, any contribution by Hall will necessarily be equal to or greater than the value of its 100% .lm3

ownership interest").

[25] Recall that *Ahlers* stated that

> [i]ndeed, even in a sole proprietorship, where 'going concern' value may be minimal, there may still be some value in the control of the enterprise; obviously, also at issue is the interest in potential future profits of a now-insolvent business.

*Norwest Bank Worthington v. Ahlers*, 485 U.S. at ----, 108 S.Ct. at 969, 99 L.Ed.2d at 180.

cial note should be made in this case that the senior right which occupies the court here arises only in bankruptcy. 11 U.S.C. s 1111(b); see discussion supra. It is not as though this creditor had contracted for a deficiency claim prior to bankruptcy. It only has a Code-created deficiency to assure it of a voice in the proceeding.

Nonetheless, the Code-created deficiency must be given equal voice and dignity with nonbankruptcy recourse claims, in order to honor the intent of Congress in enacting Section 1111(b) in the first place. Nonrecourse debt is treated as recourse, for purposes of bankruptcy, precisely in order to trigger the operation of the absolute priority rule. 124 Cong Rec H11103-11104, 95th Cong, 2d Sess (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards). No distinction should thus be drawn when evaluating the value of the particular senior right conferred by way of Section 1111(b), namely, control over the enterprise to the exclusion of equity interests.

Here, the holder of this deficiency claim could

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either prevent confirmation or at the least would enjoy whatever upside gain the enterprise might enjoy should the market in Austin return to health, but for the capital infusion. Phoenix' unsecured claim would, in the absence of the cash infusion, give it a measure of control over the very building which also stands as collateral for its secured debt. These are valuable rights indeed, though they are difficult to quantify. [27] On the other hand, Phoenix would not have the capital infusion proposed under this plan and the enterprise itself would be $500,000 poorer without it, but for the equity infusion.

In order to compensate Phoenix, the debtor may have to confer certain offsetting rights, such as an ownership participation, an option to purchase, or some other such device "dependent on the facts

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[26] The Court observed that the mechanism to be employed "in the case of a solvent company ... will be dependent on the facts and requirements of each case." Id. There is no logical reason for the rule to be any different in the case of an insolvent entity into which current equity intends to infuse

and requirements of each case." *Consolidated Rock Products, Co. v. DuBois*, 312 U.S. at 529-30, 61 S.Ct. at 686-87, 85 L.Ed. at 995. On the other hand, the facts of a given case may well satisfy the need for full compensation without further adjustment. In this case, for example, current management is deemed by all to be superior, the plan's duration is relatively short, and all of the capital contributed goes into the operation and maintenance of the very asset which secures Phoenix' secured claim. Under these circumstances, it is difficult to find that the rights which Phoenix enjoys by virtue of its Code-created deficiency require further compensation than they already have, in deference to Justice Douglas' advise that

> [p]ractical adjustments are necessary. The method of effecting full compensation for senior claimants will vary from case to case.

*Consolidated Rock Products, Co. v. DuBois*, 312 U.S. at 529-30, 61 S.Ct. at 686-87, 85 L.Ed. at

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995. [28] For these reasons, the court believes the proposed plan should be approved as it stands.

## III. CONCLUSION

For all of the foregoing reasons, the court finds and concludes that the debtor's plan as currently proposed should be approved and confirmed. An order consistent with this opinion will be entered.

So ORDERED.

SIGNED June 5, 1989.

/s/ Leif M.Clark
LEIF M. CLARK
U. S. BANKRUPTCY JUDGE

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new capital in exchange for an ownership interest which will, by definition, deprive the senior unsecured creditors of some or all of their control over the venture. See *Group of Insti-*

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*tutional Investors v.Chicago, Milwaukee, St. Paul & Pacific RailRoad Co.*, 318 U.S. 523, 570, 63 S.Ct. 727, 751, 87 L.Ed. 959, 1010 (1943).

27 The evidence at trial strongly suggests that the lender does not know what's good for it, as the value of the property is likely to deteriorate in the hands of the lender, based upon its past history with properties it has re-acquired.

28 In another case, a court might require further provisions on the lines of equity participations, back-in ownerships, profit participations, or the like.